EXHIBIT 1

TESTIMONY OF

BROOKSLEY BORN, CHAIRPERSON

COMMODITY FUTURES TRADING COMMISSION

CONCERNING THE OVER-THE-COUNTER DERIVATIVES MARKET

BEFORE THE U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING AND FINANCIAL SERVICES

JULY 24, 1998

Mr. Chairman and Members of the Committee:

I. Introduction

I am pleased to represent the Commodity Futures Trading Commission ("CFTC" or "Commission") here today to testify concerning H.R. 4062, the "Financial Derivatives Supervisory Improvement Act of 1998," and the regulation of the over-the-counter ("OTC") derivatives market.

The Commission has significant concerns about H.R. 4062 and urges this Committee to consider it very carefully. H.R. 4062 would prevent the Commission from taking action in market or other emergencies arising in that portion of the OTC derivatives market within its statutory authority, would forbid the Commission from enforcing its existing laws and regulations relating to certain transactions in that market, and would bar the Commission from addressing new developments in that market. It would for the first time eliminate the independence of the Commission as a regulatory agency by subjecting its actions relating to the OTC derivatives market to prior approval by the Secretary of the Treasury. It would also legalize certain OTC futures contracts that have been forbidden by law since 1982. These profound changes in the law, having significant impact on long-standing regulation of the OTC derivatives market, should be thoroughly examined. Important public interests would be harmed by their adoption.

This legislative initiative was triggered by the Commission's decision to evaluate the continuing appropriateness of its own regulations regarding OTC derivatives in light of changes in the OTC derivatives market over the past five years. That decision was part of an ongoing Commission effort to review its regulations to determine whether they should be streamlined, modernized or revised to reduce unnecessary regulatory burdens. No emergency has been

created by the Commission's review which would justify the profound legal changes in H.R 4062.

II. The OTC Derivatives Market

Derivative instruments are contracts whose value depends upon (or derives from) the value of one or more underlying reference rates, indexes or assets. The classes of underlying assets from which a derivative instrument may derive its value include physical commodities (e.g., agricultural products, metals, or petroleum), financial instruments (e.g., debt and interest rate instruments or equity securities), indexes (e.g., based on interest rates or securities prices), foreign currencies, or spreads between the value of such assets. Derivative contracts may be listed and traded on organized exchanges or privately negotiated between the parties. Derivatives executed off of an exchange or board of trade are referred to as over-the-counter ("OTC") derivatives.

OTC derivatives are similar in structure and purpose to exchange-traded futures and options. Like exchange-traded derivatives, OTC derivatives are used for risk shifting and speculation. End-users employ OTC derivatives to hedge risks from volatility in interest rates, foreign exchange rates, commodity prices, and equity prices, among other things. These instruments also are used to assume price risk in order to speculate on price changes. Participants in the OTC derivatives market include commercial corporations, insurance companies, mutual funds, pension funds, colleges and universities, governmental bodies, banks, other financial service providers, and individuals with significant assets.

A simple example will illustrate how exchange-traded and OTC derivatives operate in a similar fashion in order to achieve the same purpose. Consider a business that has issued a note with a variable rate of interest payable semiannually over a fixed time period. If the firm

becomes concerned that interest rates might rise over the remaining life of the note and that it might therefore be paying higher rates, the firm may wish to consider ways in which it can transform its variable rate liability into a fixed rate liability.

One way of doing this would be for the firm to sell a series of exchange-traded Eurodollar futures contracts, each of which matured on or about one of the note's interest payment dates. Because the cost of a Eurodollar futures contract falls as interest rates rise, profits from the futures position could be used to cover the difference between market rates payable on the note and the fixed rate established by the firm's transaction on the futures exchange. Alternatively, the firm could enter into a swap agreement in the OTC derivatives market in which it paid a fixed interest rate and received a variable interest rate based on the market rate with payment dates corresponding to the interest payment dates of the note.

Either method would allow the firm to convert its variable rate exposure to a fixed rate that would not fluctuate with changes in the interest rate market. The firm might choose exchange-traded futures for reasons of liquidity and transparency. In addition, if the firm chose exchange-traded futures, the risk of counterparty default would be assumed by the exchange's clearinghouse, which serves as the counterparty to both buyer and seller in every exchange transaction. If the firm chose to enter a contract on the OTC market, it would have to bear that risk of counterparty default itself. On the other hand, the OTC market permits parties to negotiate greater customization of terms, which may be a significant consideration if the size of the firm's exposure, or the dates on which its payments become due, do not correspond to the standardized terms of exchange-traded contracts.

Use of OTC derivatives has grown at a rapid rate over the past few years. According to the most recent market survey by the International Swaps and Derivatives Association ("ISDA"),

the notional value of new transactions reported by ISDA members in interest rate swaps, currency swaps, and interest rate options during the first half of 1997 increased 46% over the previous six-month period.[1] The notional value of outstanding contracts in these instruments was reportedly $28.733 trillion worldwide, up 12.9% from year-end 1996, 62.2% from year-end 1995, and 154.2% from year-end 1994.[2] ISDA's 1996 market survey noted that there were 633,316 outstanding contracts in these instruments as of year-end 1996, an increase of 47% from year-end 1995, which in turn represented a 40.7% increase over year-end 1994.[3] An October 1997 report by the General Accounting Office ("1997 GAO Report") suggests that the market value of OTC derivatives represents about 3 percent of the notional amount.[4] Applying the 3 percent figure to the most recent ISDA notional value for contracts outstanding for the first half of 1997 indicates that the worldwide market value of these OTC derivatives transactions is over $860 billion.

The OTC derivatives market is substantially larger than the ISDA survey data indicate since the data are limited to transactions involving ISDA members only and to transactions in only three kinds of instruments among the many instruments being traded. With a growing market have come growing profits for OTC derivatives dealers. According to an industry

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1 International Swaps and Derivatives Association, *Summary of Recent Market Survey Results,* ISDA Market Survey, available at http://www.isda.org.

2 *Id.*

3 *Id.*

4 General Accounting Office, GAO/GGD-98-5, *OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes* (1997) 3, n.6 ("1997 GAO Report"). The notional amount represents the amount upon which payments to the parties to a derivatives transaction are based and is the most commonly used measure of outstanding OTC derivatives transactions. Notional amounts generally overstate the amount at risk in such transactions.

publication, OTC derivatives trading revenues reached a record $2.35 billion during the first quarter of 1998, exceeding the previous record by $100 million.[5]

III. Commission Regulation of OTC Derivatives

The CFTC or its predecessor agency, the Commodity Exchange Authority, has regulated derivative instruments for almost three-quarters of a century. Its authority is contained in the Commodity Exchange Act ("CEA" or "Act"), which is the primary federal law governing regulation of derivative transactions. The CEA vests the CFTC with exclusive jurisdiction over futures and commodity option transactions whether they occur on an exchange or over the counter. The Act generally contemplates that, unless exempted, futures and commodity options are to be sold through Commission-regulated exchanges which provide the safeguards of open and competitive trading, a continuous market, price discovery and dissemination, and protection against counterparty risk. Thus, the Act and CFTC regulations establish a regulatory framework for exchange-trading of futures and options and provide for Commission oversight of intermediaries engaging in such transactions on behalf of customers.

Through its regulation of derivative instruments, the CFTC attempts to assure that: (i) prices are established in an open, competitive and transparent manner free from price manipulation; (ii) the financial integrity of the markets is maintained; and (iii) customers are protected from fraud and other abusive practices. The Commission accomplishes these goals through its surveillance of the markets; its establishment of regulations governing, among other things, minimum capital requirements for market intermediaries, segregation of customer funds, risk disclosure for customers, and recordkeeping and reporting by commodity professionals; its

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5 *First Quarter Trading Revenues Soar to Record Levels*, Swaps Monitor, May 18, 1998, at 1.

oversight of self-regulatory organizations; and when necessary, emergency intervention or enforcement action.

Transactions in OTC futures and options are generally prohibited under the Act unless explicitly excluded or exempted from the exchange-trading requirement of the CEA. The Commission's enforcement docket has historically included numerous proceedings against persons trading in OTC derivatives that were outside the scope of any exemption or exclusion.[6] For example, the Commission currently has four pending actions involving hedge-to-arrive contracts charging that the transactions constituted illegal OTC futures or options contracts. Similarly, its many cases against bucket shops are based on the fact that such operations sell derivatives off a regulated exchange and are also specifically prohibited by Section 4b of the Act.

The CEA specifically excludes certain types of OTC derivatives from the requirements of the Act. The so-called Treasury Amendment to the CEA provides that the CEA does not apply to OTC transactions in foreign currencies, government securities and certain other financial instruments.[7] Options on securities and options on securities indexes also are excluded from the

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6 *See, e.g., In the Matter of MG Refining and Marketing, Inc., et al.*, CFTC Docket No. 95-14, 1995 WL 447455 (filed Jul. 27, 1995); *Commodity Futures Trading Commission v. Noble Metals Intern., Inc.*, 67 F.3d 766 (9th Cir. 1995), *cert. denied sub nom. Schulze v. Commodity Futures Trading Commission*, 117 S.Ct. 64 (1996); *Commodity Futures Trading Commission v. American Metals Exchange Corp.*, 991 F.2d 71 (3d Cir. 1993); *Commodity Futures Trading Commission v. Co Petro Marketing Group, Inc,* 680 F.2d 573 (9th Cir. 1982).

7 The Treasury Amendment provides that nothing in the CEA shall be applicable to "transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade." Section 2(a)(1)(A)(ii) of the Act, 7 U.S.C. § 2(ii).

Act and are subject to the jurisdiction of the Securities and Exchange Commission ("SEC").[8]

In addition, the Commission itself has exempted certain types of OTC derivative transactions from specified provisions of the CEA. For example, under Section 4c of the Act, the Commission has the authority to allow options to be traded over-the-counter under such terms and conditions as the Commission may prescribe. Pursuant to this authority, the Commission has by regulation exempted certain OTC options from most provisions of the Act pursuant to specified terms and conditions.[9]

The Futures Trading Practices Act of 1992 gave the Commission additional authority to exempt transactions from certain provisions of the Act, including the requirement in Section 4(a) of the Act that futures must be traded on exchanges. Section 4(c)(2) of the Act provides that the

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8 Section 2(a)(1)(B)(i), 7 U.S.C. § 2a (i). The SEC also has jurisdiction over foreign currency options, but only when they are traded on a national securities exchange. Section 4c(f) of the Act, 7 U.S.C. § 6c(f). The CFTC has jurisdiction over foreign currency options when traded on a board of trade. Sections 2(a)(1)(A)(ii) and 4c(b) of the Act, 7 U.S.C. §§ 2(ii) and 6c(b).

9 The Commission has exempted trade options. Trade options are off-exchange commodity options offered and sold to commercial counterparties whose business involves the commodity (or by-products thereof) that is the subject of the transaction and who enter into the transactions for purposes related to that business. Commission Rule 32.4(a), adopted in 1976, permits the sale of OTC commodity options in circumstances in which the offeror "has a reasonable basis to believe that the option is offered to a producer, processor or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction" and that such commercial party is offered or enters into the transaction "solely for purposes related to its business as such." 17 C.F.R. § 32.4.

This trade option exemption does not extend to the basic agricultural commodities enumerated in the CEA. Due to concerns over historical abuses relating to agricultural options, they were subject to a statutory ban until 1982, and the Commission imposed a regulatory prohibition on OTC agricultural options thereafter. Recently, however, major changes in U.S. farm policy have created a growing demand in the marketplace for innovative agricultural risk management tools. Therefore, earlier this year the Commission implemented a pilot program to permit OTC agricultural trade options, subject to regulatory safeguards. 63 Fed. Reg. 18821 (Apr. 16, 1998).

Commission may grant an exemption if the Commission determines that (i) the transaction would be entered into solely between defined "appropriate persons"; (ii) the transaction would not have a material adverse effect on the ability of the Commission or any regulated exchange to discharge its regulatory or self-regulatory duties under the Act; and (iii) the exemption would be consistent with the public interest and the purposes of the Act. Section 4(c)(5) explicitly authorizes the Commission to grant exemptions for swap agreements and hybrid instruments. The Commission may grant exemptions "either unconditionally or on stated terms or conditions."[10] Thus, the Commission has been given the flexibility and authority to tailor its regulatory program to fit the changing realities of the marketplace and the changing needs of market participants.

Pursuant to Section 4(c), the Commission adopted regulations in 1993 exempting certain swap agreements and hybrid instruments from some -- but not all -- provisions of the Act subject to specified terms and conditions. Part 35 of the Commission's Regulations exempts certain swaps from provisions of the Act other than the antifraud provisions, the anti-manipulation provisions, and Section 2 (a)(1)(B).[11] Thus, swaps exempted under Part 35 may be traded over the counter without violation of the CEA. To be eligible for exemptive treatment under Part 35, an agreement: (1) must be a swap agreement as defined in Rule 35.1(b)(1); (2) must be entered into solely between specified eligible swap participants; (3) must not be a part of a fungible class of agreements that are standardized as to their material economic terms; (4) must include as a material consideration in entering into the agreement the creditworthiness of a party with an

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10 Section 4(c)(1) of the Act, 7 U.S.C. § 6(c)(1).

11 17 C.F.R. Part 35.

obligation under the agreement; and (5) must not be entered into and traded on or through a multilateral transaction execution facility.

The criteria contained in the swaps exemption were designed to assure that exempted swap agreements meet the requirements set forth by Congress in Section 4(c) of the CEA and to "promote domestic and international market stability, reduce market and liquidity risks in financial markets, including those markets (such as futures exchanges) linked to the swap market and eliminate a potential source of systemic risk."[12] The criteria restrict OTC swap transactions to bilateral, customized transactions between financially sophisticated persons or institutions. The Part 35 exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual counterparties to each other is effectively eliminated, nor does it extend to transactions executed on exchanges.

Part 34 of the Commission's Regulations exempts certain hybrid instruments from specified provisions of the Act, including the exchange-trading requirement.[13] Under the rules, a hybrid instrument is defined as a financial instrument that combines elements of an equity, debt or depository instrument with elements of a futures or option contract. Part 34 exempts hybrid instruments from most requirements of the CEA to the extent that they are predominantly securities or depository instruments and are regulated as such.[14]

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12 58 Fed. Reg. 5587, 5588 (Jan. 22, 1993).

13 17 C.F.R. Part 34.

14 Part 34 exempts hybrids, and those transacting in and/or providing advice or other services with respect to such hybrids, from all provisions of the CEA except Section 2(a)(1)(B) and thus permits OTC transactions in such hybrids, subject to the following requirements: (1) a requirement that the issuer must receive full payment of the hybrid's purchase price; (2) a prohibition on requiring additional out-of-pocket payments to the issuer during the hybrid's life or at its maturity; (3) a prohibition on marketing the instrument as a futures contract or commodity option; (4) a prohibition on settlement by

As part of the 1992 legislation, Congress also directed the CFTC to conduct a study of OTC derivatives to determine the need, if any, for additional regulation.[15] In requesting the study, Congress recognized that the Commission, based on its expertise in derivatives, was the appropriate body to study the issue. The Commission carried out its Congressional mandate to study the market in 1993 and concluded that no fundamental changes in the regulatory structure for OTC derivatives were necessary at that time.[16]

IV. Regulatory Issues Posed by the Evolving Marketplace

Five years have passed since the Commission adopted its Part 34 and Part 35 regulations and last studied the OTC derivatives market. Since that time, the OTC derivatives market has changed significantly. When Congress gave the Commission its Section 4(c) exemptive authority in 1992, the Conference Committee expressly stated that the provision would permit the Commission to review its exemptions to "respond to future developments."[17] The CFTC strongly believes that, in order to carry out its statutory mandate responsibly, it must keep its regulatory system in tune with changes in the market it oversees. Failure to keep pace with the changing market would stifle the capacity of U.S. firms to meet global competitive challenges, would create a cloud of legal uncertainty over the applicability of outdated rules to new products

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delivery of an instrument specified as a delivery instrument in the rules of a designated contract market; (5) a requirement that the hybrid be initially sold or issued subject to federal or state securities or banking laws to persons permitted thereunder to purchase the instrument; and (6) a requirement that the sum of the values of the commodity-dependent components of a hybrid instrument be less than the value of the commodity-independent components.

15 *See* H.R. Conf. Rep. No. 102-978, 102d Cong., 2d Sess. 83 (1992)(Conference Report to accompany P.L. 102-546, the Futures Trading Act of 1992).

16 *See* CFTC, *OTC Derivatives Markets and Their Regulation* (1993).

17 *See* H.R. Conf. Rep. No. 102-978, 102d Cong., 2d Sess. 81 (1992).

and innovative transactions, and would erode the regulatory system's ability to protect customers and to preserve the financial integrity of that market.

Consistent with these responsibilities, the CFTC over the past 18 months has been engaged in a comprehensive regulatory reform effort designed to update, to modernize and to streamline its regulations and to eliminate undue regulatory burdens.[18] The Commission's

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18 *See, e.g.*, Revised Procedures for Commission Review and Approval of Applications for Contract Market Designation and of Exchange Rules Relating to Contract Terms and Conditions, 62 FR 10434 (Mar. 7, 1997); Final Rulemaking Concerning Contract Market Rule Review Procedures, 62 FR 10427 (Mar. 7, 1997); Contract Market Rule Review Procedures, 62 FR 17700 (Apr. 11, 1997); Electronic Filing of Disclosure Documents With the Commission, 62 FR 18265 (Apr. 15, 1997); Recordkeeping; Reports by Futures Commission Merchants, Clearing Members, Foreign Brokers, and Large Traders, 62 FR 24026 (May 2, 1997); Bunched Orders and Account Identification, 62 FR 25470 (May 9, 1997); Alternative Methods of Compliance With Requirements for Delivery and Retention of Monthly, Confirmation and Purchase-and-Sale Statements, 62 FR 31507 (June 10, 1997); Interpretation Regarding Use of Electronic Media by Commodity Pool Operators and Commodity Trading Advisors for Delivery of Disclosure Documents and Other Materials, 62 FR 39104 (July 22, 1997); Securities Representing Investment of Customer Funds Held in Segregated Accounts by Futures Commission Merchants, 62 FR 42398 (Aug. 7, 1997); Concept Release on the Denomination of Customer Funds and the Location of Depositories, 62 FR 67841 (Dec. 30, 1997); Account Identification for Eligible Bunched Orders, 63 FR 695 (Jan. 7, 1998); Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers, 63 FR 2188 (Jan. 14, 1998); Requests for Exemptive, No-Action and Interpretative Letters, 63 FR 3285 (Jan. 22, 1998); Voting by Interested Members of Self-Regulatory Organization Governing Boards and Committees, 63 FR 3492 (Jan. 23, 1998); Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market, 63 FR 3708 (Jan. 26, 1998); Distribution of Risk Disclosure Statements by Futures Commission Merchants and Introducing Brokers, 63 FR 8566 (Feb. 20, 1998); Amendments to Minimum Financial Requirements for Futures Commission Merchants, 63 FR 12713 (Mar. 16, 1998); Two-Part Documents for Commodity Pools, 63 FR 15112 (Mar. 30, 1998); Rules of Practice; Proposed Amendments, 63 FR 16453 (Apr. 3, 1998); Trade Options on the Enumerated Agricultural Commodities, 63 FR 18821 (Apr. 16, 1998); Trading Hours, 63 FR 24142 (May 1, 1998); Recordkeeping, 63 FR 30668 (June 5, 1998); Elimination of Short Option Value Charge, 63 FR 32725 (June 16, 1998); Futures-Style Margining of Commodity Options, 63 FR 32726 (June 16, 1998); Changes in Trading Hours, 63 FR 33848 (June 22, 1998).

review of its regulatory system would be incomplete in an important respect if it did not address the Commission's rules regarding OTC derivatives.

As noted earlier, the five years since the adoption of the Part 34 and Part 35 rules have been characterized by dramatic growth in the volume and value of OTC derivative transactions. Furthermore, the structure of the OTC derivatives market has changed significantly, creating a potential divergence between the Commission's regulations and the realities of the marketplace. For example, since 1993 the proliferation of OTC instruments has resulted in broader participation in the swaps market, encompassing new end-users of varying degrees of sophistication. This evolution in the market requires the Commission to evaluate whether it should broaden the definition of eligible swaps participants contained in its current rule and whether recordkeeping, sales practice, or other protections may now be appropriate. I cannot overemphasize that the Commission has not formulated any views, tentative or otherwise, on these questions. It simply is exercising its responsibility to make inquiry.

The swaps market also has experienced a proliferation of new products and proposed new trading systems. While the Part 35 exemption does not extend to swap agreements that are part of a fungible class of agreements, market information indicates that some swap agreements have become increasingly standardized, indicating a need to consider broadening the exemption under appropriate terms and conditions. Furthermore, the swaps exemption does not permit clearing of swaps or trading of them through multilateral transaction execution facilities, but developments in the marketplace have indicated a significant demand for both. For example, the London Clearing House recently filed a petition with the Commission for an exemption under Section 4(c) of the CEA to provide swap clearing services, and other organizations have

indicated that they are developing similar facilities.[19] Swaps clearing and execution facilities pose regulatory issues concerning systemic risk and price discovery that are not involved in privately negotiated, bilateral off-exchange swaps transactions. Any consideration of permitting clearing and execution facilities must also take into account the need to promote even-handed regulation and fair competition between any such new facilities and existing futures and option exchanges.

An additional concern is the legal uncertainty that may result from trading in OTC derivative instruments that do not comply with the terms and conditions of the current swaps exemption. To the extent that such instruments are futures or options and are not subject to another exemption in the Act, they would violate the CEA. Moreover, Section 12(e)(2)(A) of the Act was enacted in order to "provide legal certainty under . . . state gaming and bucket shop laws for transactions covered by the terms of an exemption" by preempting the application of such state laws.[20] OTC derivative instruments that are outside the Commission's exemptions are also outside the protective umbrella of that preemption and may be deemed illegal under state law.

Another factor suggesting a need to request information about the OTC derivatives market arises from the large, well-publicized financial losses in the OTC derivatives market since the 1993 exemptions were adopted. While OTC derivatives serve important economic functions, these products, like all complex financial instruments, can present significant risks if misused or misunderstood. The 1997 GAO Report, entitled *OTC Derivatives: Additional*

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19 The Commission has requested public comment on the London Clearing House petition. 63 FR 36657 (July 7, 1998).

20 H.R. Conf. Rep. No. 102-978, 102 Cong., 2d Sess. 80 (1992)

Oversight Could Reduce Costly Sales Practice Disputes, chronicles 360 end-user losses, of which 58% reportedly involved sales practice concerns.[21]

Major OTC derivatives losses relating to the recent instability in Asian financial markets are currently being reported, and more may be anticipated. According to a recent press report, J.P. Morgan "last year declared it had $659 million in nonperforming assets, 90% of which were defaults from Asian derivative counterparties."[22] The same article states that Chase Manhattan "saw its 'nonperforming' assets in Asia triple in the first three months of 1998, to $243 million, due in part to derivatives."[23]

Concerns have also been raised regarding the potential effect of derivatives losses on the investing public[24] and on the financial system as a whole. As Alan Greenspan, the Chairman of the Board of Governors of the Federal Reserve System, stated on May 7, 1998:

> the major expansion of the over-the-counter derivatives market has occurred in [a] period of unparalleled prosperity. . . [in] which losses generally, in the financial system, have been remarkably small . . . And as a consequence of that, I don't think that one will fully understand or know how vulnerable that whole structure is until we have it really tested. And eventually that's going to happen.[25]

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21 1997 GAO Report at 10. S*ee also* Jerry Markham, Commodities Regulation: Fraud, Manipulation & Other Claims, § 27.05, at 27-30 – 27-34 (Supp. 1997) (presenting an extensive array of major OTC derivatives losses in 1994 alone).

22 Bernard Baumohl, *The Banks' Nuclear Secrets*, Time, May 25, 1998, at 50.

23 *Id.* at 46.

24 *See, e.g.,* AARP/CFA/NASAA *Background Report: The Five Biggest Problems 'Legitimate' Investing Poses for Older Investors* (1995) (discussing "hidden derivatives in investment products touted as 'safe.")

25 Transcript for CNBC-TV *"Power Lunch,"* May 7, 1998, provided by Video Monitoring Services of America, L.P.

Allegations of serious sales practice abuses by OTC derivatives dealers have been made in recent years in cases involving major losses by derivatives end-users. For example, an affiliate of Bankers Trust was charged with fraud in the sale of OTC derivatives in some well publicized cases involving Proctor and Gamble, Gibson Greeting Cards, and other large entities.[26] Likewise, Merrill Lynch recently agreed to pay $400 million to Orange County, California to settle claims involving sales of derivatives that caused Orange County's bankruptcy and is reportedly in settlement negotiations with the Government of Belgium relating to its loss of $1.2 billion in derivatives trading. Furthermore, the 1997 GAO Report recommended that the SEC and the CFTC examine the experience of the members of the Derivatives Policy Group, an organization of five large OTC derivatives dealers, with respect to the voluntary sales practice standards they have adopted and also recommended a comprehensive review of sales practices and counterparty relationships in the OTC derivatives market.[27]

Losses resulting from misuse of OTC derivatives instruments or from sales practice abuses in the OTC derivatives market can affect many Americans -- many of us have interests in the corporations, mutual funds, pension funds, insurance companies, municipalities and other entities trading in these instruments. Obviously, regulation cannot and should not seek to eliminate market losses, but under the circumstances it is appropriate to request information regarding industry practices to assess whether they merit a regulatory response.

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26 *See In the Matter of BT Securities Corp.*, CFTC Docket No. 95-3, 1994 WL 711224 (Dec. 22, 1994) (Gibson Greeting Cards); *Procter and Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996).

27 1997 GAO Report at 137-38.

In light of these sales practice issues and the rapid development and evolution of the market, federal financial agencies are reviewing and revising their regulatory requirements regarding OTC derivatives. For example, on April 23, 1998, the Office of Thrift Supervision of the Department of the Treasury proposed what it termed "a comprehensive revision" of its "outmoded regulations" in response to "the development of new financial derivative instruments."[28] In addition, the SEC proposed rules in December 1997 that would create for the first time a comprehensive SEC regulatory regime for certain very large OTC derivatives dealers.[29] Not surprisingly, the CFTC as the expert federal agency in derivatives transactions also is reviewing its existing regulations relating to OTC derivatives, as discussed below.

V. The Commission's Concept Release on OTC Derivatives

In order to examine whether its regulatory framework relating to OTC derivatives remains appropriate in light of market developments since that framework was first adopted, the Commission issued a Concept Release on OTC Derivatives on May 7, 1998.[30] (See Attachment 1.) The Concept Release seeks public comment on whether the Commission's current exemptions for swaps and hybrid instruments remain appropriate as to, among other things, the

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28 Financial Management Policies: Financial Derivatives, 63 Fed. Reg. 20252 (Apr. 23, 1998). *See also* Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, 63 Fed. Reg. 20191 (Apr. 23, 1998).

29 OTC Derivatives Dealers, 62 Fed. Reg. 67940 (Dec. 30, 1997). The SEC has jurisdiction over OTC options on securities and options on securities indexes under the CEA. 7 U.S.C. § 2a(i). The GAO has reported that the SEC's jurisdiction extends to about 1.4% of the instruments in the OTC derivatives market. 1997 GAO Report at 42. Nonetheless, the SEC proposal purports to regulate trading in all OTC derivative instruments by OTC derivatives dealers operating under its proposed rule, including, for example, commodity swaps and other instruments which are clearly not within the SEC's jurisdiction. The proposal also purports to permit trading in certain OTC derivative instruments which are not exempt under the CEA and the Commission's regulations.

30 63 Fed. Reg. 26114 (May 12, 1998).

definitions of eligible transactions and eligible participants and the prohibitions against fungible swaps, swaps clearing and multilateral swaps transaction execution facilities. It asks whether the current prohibitions on fraud and manipulation are sufficient to protect the public or whether the Commission should consider additional terms and conditions relating to registration, capital, internal controls, sales practices, recordkeeping or reporting. The Concept Release also asks whether, if additional oversight of those markets were required, such oversight would best be administered by the Commission itself or through self-regulatory organizations.

The Concept Release does not propose any modification of the Commission's regulations, nor does it presuppose that any modification is needed. It merely asks for information about current realities in the marketplace and views as to the appropriate Commission response, if any. The Commission wishes to draw on the knowledge and expertise of a broad spectrum of interested parties, including OTC derivatives dealers, end-users of derivatives, futures and option exchanges, other regulatory authorities, and academicians. The Commission would also welcome the comments of the members of this Committee and their constituents.

In issuing the Concept Release, the Commission has no preconceived result in mind. The Commission is open to evidence in support of broadening its exemptions, evidence indicating a need for additional safeguards and evidence for maintaining the status quo. Serious consideration will be given to the views of all interested persons as well as the Commission's own research and analysis. In the event that the Commission believes that proposed regulatory changes might enhance the competitiveness of the OTC derivatives market or provide necessary regulatory safeguards, such proposed changes would first be published for additional public

comment before any final rules would be considered for adoption. Moreover, changes which impose new regulatory obligations or restrictions, if any, would be applied prospectively only.

The Concept Release explicitly states that it does not in any way alter the current status of any instrument or transaction under the CEA. All currently applicable exemptions, interpretations, and policy statements issued by the Commission regarding OTC derivatives products remain in effect and may be relied upon by market participants.

Concerns have been expressed about the Concept Release. Many of the concerns reflect a lack of understanding as to the nature and purpose of the Concept Release or a desire to avoid government oversight. Indeed, arguments have been made that OTC derivatives do not need government regulation or oversight of any kind. These arguments ignore that the OTC derivatives market is already subject to regulation by the Commission through the CEA's prohibition of OTC futures and options that are not exempted from the exchange-trading requirement, through the terms and conditions of the Commission's exemptions and through the Commission's fraud and manipulation prohibitions. The Commission agrees that unduly burdensome or duplicative regulation of the OTC derivatives market would not be in the public interest. However, it is the Commission's statutory mandate to oversee and safeguard the derivatives market, where billions of dollars of Americans are at risk.

Additionally, there have been unsupported claims that the Concept Release has created concerns about legal certainty that have disrupted the OTC derivatives market and driven business offshore. The Commission has yet to be provided with any empirical evidence that the Concept Release has caused disruption in the market. Commission staff has looked for signs of disruption and has not found any. The Commission does not believe that this robust, multi-trillion dollar market is so fragile that mere governmental examination of it will cause

dislocation. Rather, in the Commission's view, the market will benefit from assuring that government regulations do not ignore developments and innovations in the marketplace. Moreover, as the Commission was careful to point out in the Concept Release, the Concept Release does not in any way alter the current legal status of any instrument.

Some argue that, having adopted exemptions for certain OTC derivatives transactions in 1993, the Commission cannot now update those exemptions to reflect the changes in the marketplace. This argument is flatly inconsistent with the intent of Congress in passing the Futures Trading Practices Act of 1992, during which the House and Senate Conference Committee noted:

> [T]he Conferees intend for the general exemptive authority. . . to allow the [CFTC] to respond to future developments in the marketplace to avoid disruption and promote responsible economic and financial innovation, with due regard for the continued viability of the marketplace and considerations related to systemic risk in financial markets.[31]

As the President's Working Group on Financial Markets ("President's Working Group") -- consisting of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the SEC and the Chairperson of the CFTC -- wrote to Congress in 1994 concerning the CFTC's regulation of the OTC derivatives market,

> [I]n order to fall within the safe harbor created by the Commodity Futures Trading Commission's (CFTC's) exemptions from the Commodity Exchange Act for swaps and other types of OTC derivatives transactions, all market participants must comply with the access and design restrictions contained in those exemptions. The CFTC's authority to reevaluate and impose conditions on exemptions for OTC derivative transactions can always be drawn

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[31] H.R. Conf. Rep. No. 102-978, 102d Cong., 2d Sess. 81 (1992).

> upon if additional constraints on these instruments were determined to be warranted.[32]

Another claim is that the Commission lacks jurisdiction with respect to OTC derivative instruments. This position is incorrect, as the President's Working Group so clearly stated in 1994. As discussed above, the CFTC has always had jurisdiction over futures and options, whether traded on an exchange or over the counter. It is the nature of the instruments, and not where they are traded, that determines jurisdiction under the CEA. [33]

The Commission is cognizant of the fact that other federal regulatory authorities have responsibility for certain aspects of the OTC derivatives market. Some OTC derivative instruments are exempted under the CEA by the Treasury Amendment and the Shad-Johnson Accord and are regulated by the SEC, the banking regulators, or the Department of the Treasury.

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32 Views of the Working Group on Financial Markets on the Recommendations of the U.S. General Accounting Office Concerning Financial Derivatives at 3, attached to a letter dated July 18, 1994, from Lloyd Bentsen, Secretary of the Treasury, to John D. Dingell, Chairman, House Committee on Energy and Commerce.

33 As the Agriculture Committee stated in 1982 in approving the amendments to the CEA adopting the Shad-Johnson Accord on the respective jurisdictions of the SEC and the CFTC:

> The committee has long recognized and accepted the inherent differences between the futures industry and the securities industry and endorses the concept of separate regulation. Basically, the CFTC will retain its traditional role of regulating markets and instruments that serve a hedging and price discovery function while the SEC will regulate markets and instruments with an underlying investment purpose.

H.R. Rep. No. 97-565, Part 1, 97th Cong., 2d Sess. 40 (1982) (House of Representatives Committee on Agriculture, Report To Accompany H.R. 5447, the Futures Trading Act of 1982).

Moreover, the SEC and the banking regulators oversee some of the institutions participating in this market. Other OTC derivative instruments and other market participants are within the CFTC's exclusive authority. Thus, coordination and cooperation among the CFTC and these agencies are very important to avoid duplication and inconsistent regulation. In its Concept Release, the Commission stated that it "anticipates that, where other regulators have adequate programs or standards in place to address particular areas, the Commission would defer to those regulators in those areas."[34]

However, each federal financial regulator must act within its own statutory authority and comply with its own statutory mandate. On March 11, 1998, the Secretary of the Treasury, Robert Rubin, on behalf of the President's Working Group, wrote to the House Committee on Government Reform and Oversight that the President's Working Group would not conduct a study of sales practices and counterparty relationships in the OTC derivatives market, as the 1997 GAO Report had recommended. In explaining that refusal, he stated,

> The Working Group is designed as a mechanism to exchange information about financial market issues that cross traditional jurisdictional lines. It works through its constituent agencies with no independent budget. The authority of the Federal Government to collect sales practice information from federally regulated entities rests with the appropriate federal regulators.
>
> In recent years, the federal financial regulators that are members of the Working Group have taken a number of measures to improve dealers' sales practices for OTC derivatives . . . . Because the issue of the relationship of parties involves differing product classes, regulatory structures, and customer profiles, we believe there may not be a "one size fits all" solution. Therefore, we believe these processes should be allowed to evolve and that, at this time, there is no need for the Working Group as a whole to take additional measures. Each financial regulatory agency will continue to decide its appropriate role.[35]

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34 63 Fed. Reg. 26119-20 (May 12, 1998).

35 Letter dated March 11, 1998, from Robert Rubin, Secretary of the Treasury, to Dan Burton, Chairman, House Committee on Government Reform and Oversight.

The Commission believes that that position was correct in March 1998 and continues to be correct today, four months later. In issuing its Concept Release, the Commission has appropriately decided to address OTC derivative issues within its statutory authority and in conformity with its statutory mandate.

VI. The Commission's Concerns Regarding H.R. 4062

H.R. 4062 raises serious concerns. This proposed legislation would for the first time eliminate the status of the Commission as an independent federal regulatory agency by subjecting its actions to prior approval by the Secretary of the Treasury. It would severely limit the CFTC's ability to fulfill its oversight responsibilities with regard to OTC derivatives transactions within its statutory authority, would result in a substantial change in the CEA, and would potentially leave the American public without federal protection in the event of an emergency in the OTC derivatives market. No justification has been offered for these sweeping changes in OTC derivatives regulation.

Since its inception, the Commission has been an independent regulatory agency. The bill would eliminate the status of the CFTC as an independent regulatory agency by requiring that it obtain permission from the Secretary of the Treasury even to propose any regulatory or enforcement action involving OTC swaps or hybrid instruments. This change in the status of the Commission would profoundly impair its regulatory effectiveness. In creating the Commission, Congress found that the independence of the CFTC was essential for the agency to carry out its regulatory mission. As the Senate Committee on Agriculture and Forestry stated:

> The proper regulatory function of an agency which regulates futures trading is to assure that the market is free of manipulation and other practices which prevent the market from being a true reflection of supply and demand. Therefore, the Agency which regulates

futures trading must have a neutral role on commodity prices. The Committee felt this neutral role can best be maintained by a completely independent agency.[36]

By requiring prior approval by the Secretary of the Treasury, Section 6(1) of the proposed legislation would effectively prohibit the CFTC from proposing or taking regulatory or enforcement actions relating to swaps or hybrid instruments. The Treasury Department has already taken the legally erroneous position that the Commission has no statutory authority over swaps in recent testimony before a House Agriculture Committee subcommittee.[37] In light of that position, the Secretary of the Treasury certainly would not approve any request by the Commission to "propose or permit any rule, regulation or order, or issue any interpretative or policy statement" relating to swaps if he were granted the absolute discretion to refuse to do so, as proposed in H.R. 4062.[38] The resulting prohibition of CFTC action would continue for an extended, indefinite period of time – until the enactment of legislation authorizing CFTC appropriations for any fiscal year after fiscal year 2000.

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36 S. Rep. No. 93-1131, 93d Cong., 2d Sess., 21 (1974)(Report on the Commodity Futures Trading Commission Act of 1974).

37 See Statement of John D. Hawke, Jr., Undersecretary for Domestic Finance, United States Department of the Treasury, before the Subcommittee on Risk Management and Specialty Crops of the House Committee on Agriculture, 1998 WL 12761017 (June 10, 1998). This position is in direct contravention of the view expressed by Secretary of the Treasury Lloyd Bentsen in 1994.

38 Even if the Secretary of the Treasury were not predisposed to deny approval of any proposal or action, the requirement that the CFTC submit its enforcement and regulatory actions to the Department of the Treasury for review and approval could lead to extensive delays in Commission action. The Commission would be required to share confidential information with another agency before an action could be brought before a judicial body. Such a system potentially would expose enforcement or regulatory decisions by the Commission to lobbying before the Treasury Department by persons potentially affected by the action. In addition, a decision by the Secretary to permit CFTC action might constitute final agency action subject to challenge in the courts, creating additional delays or grounds for challenging the CFTC's enforcement and regulatory actions.

This provision could prevent the CFTC from adopting new regulations or policies to address a market crisis or financial emergency in the OTC derivatives market.[39] We have entered a period of substantial volatility in the world financial markets with recent enormous losses in derivatives reported in connection with Asian financial instability. If a crisis were to occur in the OTC derivatives market after enactment of the proposed legislation, the Commission would be unable to respond with any meaningful action: the Commission's hands would be tied. Since aspects of the OTC derivatives market are within the CFTC's exclusive jurisdiction, no other federal regulator would be able to react with emergency action in such spheres, creating a dangerous gap in regulation.

The provision could also prevent the Commission from enforcing its current fraud and manipulation prohibitions applicable to certain OTC swap transactions. Under Section 6(1) the CFTC would apparently be prohibited from conducting an enforcement investigation or issuing a cease-and-desist order in an enforcement case involving fraud or manipulation in swaps transactions eligible for exemption. Thus, for example, the Commission would not have been able to issue its cease-and-desist order to an affiliate of Bankers Trust in a case involving fraud in the sale of swaps. In the Matter of BT Securities Corp., CFTC Docket No. 95-3, 1994 WL 711224 (December 22, 1994). Similarly, the Commission recently issued an order finding that Sumitomo Corporation engaged in manipulation of the U.S. copper markets in violation of the

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[39] While Section 6(1) purports to be limited to those swaps and hybrid instruments to which a depository institution or a securities broker-dealer is a party, it would have the sweeping effect of preventing any regulation or policy of general applicability because of the participation of such entities in the OTC derivatives market. It would also prevent enforcement of the law as to such entities while permitting enforcement against all other swaps market participants. Thus, Section 6(1) could raise significant issues under the Due Process Clause of the Fifth Amendment to the U.S. Constitution by mandating disparate treatment of similarly situated market participants.

CEA. The Commission imposed a cease-and-desist order and $150 million in civil penalties and restitution related to manipulative activity involving OTC derivatives transactions as well as transactions on the London Metal Exchange. That investigation is currently continuing with respect to individuals and institutions, but could not consider the use of swaps if the proposed legislation were passed.

In addition, the scope of Section 6(1) is ambiguous and likely would create significant legal uncertainty as to the Commission's legal authority. For example, the term "eligible for exemption under part 34 or 35" is unclear. It could be construed to prohibit CFTC action with regard to swap or hybrid instrument transactions as long as the instruments were theoretically eligible for the Part 34 or Part 35 exemption even though the instruments did not in fact comply with the terms and conditions set forth in those exemptions. Therefore, the Commission might no longer be able to enforce the terms and conditions of its current regulatory exemptions for swaps and hybrid instruments or to investigate possible violations of those terms and conditions. Thus, as a result of the proposed legislation, the Commission might be required to abandon ongoing investigations and inquiries.

In fact, Section 6(1) is sufficiently ambiguous that it might also be interpreted to prevent the Commission from amending its exemptions to reflect new developments in the marketplace. For example, the Commission's exemption for swaps currently prohibits swaps clearing and swaps exchange trading. The draft legislation might prevent the Commission from creating a regulatory framework for clearing and exchange trading of swaps despite increasing interest in establishing such operations and might require the Commission to withhold action on the pending London Clearing House petition to clear swaps and on other similar requests. Thus, either innovation in the marketplace would be stifled, or swaps clearing and exchange trading

could develop in an unregulated manner in violation of the Commission's regulations and in direct competition with existing futures and option exchanges.

H.R. 4062 would make other fundamental and unwarranted changes in federal policy regarding the derivatives markets. For example, it would amend the Shad-Johnson Accord and retroactively legalize certain OTC futures contracts on non-exempt securities. The Shad-Johnson Accord clarified the respective jurisdictions of the SEC and CFTC and was codified in the CEA in 1982. Section 6(2) of H.R. 4062 would amend the Shad-Johnson Accord by "temporarily" eliminating the prohibitions in Section 2(a)(1)(B)(v) of the CEA against OTC futures contracts on nonexempt securities and on securities indexes that do not reflect a substantial segment of the market. Careful consideration by Congress of the public policy reasons underlying the long-standing statutory prohibition of such instruments and its proposed elimination is needed prior to acting on this provision.

While permitting OTC transactions in these instruments, Section 6(2) would continue the current prohibition on exchange trading in them. If OTC transactions in these instruments were to be permitted, Congress should certainly consider whether such instruments should also be permitted to be traded on the safer, more regulated exchange markets, as they currently are in a number of foreign countries. The U.S. futures exchanges would have a valid competitive interest in being able to trade these instruments under such circumstances.

The proposed legislation would also create a new federal agency, the Working Group on Financial Derivatives, and authorize it to review and to recommend changes to regulations governing both OTC and exchange-traded derivative markets -- including futures and commodity option exchanges regulated by the CFTC and securities option exchanges regulated by the SEC. This new body, which would be chaired by the Secretary of the Treasury, would

have only one representative each from the CFTC and the SEC, but three members from the Department of the Treasury, two from the Federal Reserve System and one from the Federal Deposit Insurance Corporation. Thus, the proposed legislation would delegate review of federal law governing derivatives markets under the jurisdiction of the CFTC and the SEC to a body dominated by banking regulators with no expertise in derivatives market regulation.

In a June 10, 1998 hearing on the OTC derivatives market conducted by the Committee on Risk Management and Specialty Crops of the House Committee on Agriculture, agencies representing six of the eight members of the proposed new Working Group contemplated by H.R. 4062 -- the Treasury Department, the Federal Reserve Board and the SEC -- testified that they have already concluded that the CFTC should no longer retain its current statutory authority with regard to the OTC derivatives market and that the Commission's jurisdiction should be transferred to and divided among themselves. The new Working Group would become a platform for these agencies to implement this transfer of the CFTC's statutory authority.

Indeed, this transfer of authority would begin under the terms of the proposed legislation. While the bill would bar the CFTC from taking actions with regard to OTC derivative instruments within its jurisdiction, other federal regulators would remain free to go forward with their plans to issue new regulations relating to the OTC derivatives market. For example, the SEC would be free to finalize its proposed new regulatory scheme applicable to OTC derivatives dealers.[40] Likewise, the Office of Thrift Supervision of the Department of the Treasury would be free to adopt its proposed comprehensive revision of regulations on derivatives.[41] Such new

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40 *See* OTC Derivatives Dealers, 62 Fed. Reg. 67940 (Dec. 30, 1997).

41 *See* Financial Management Policies: Financial Derivatives, 63 Fed. Reg. 20252 (Apr. 23, 1998).

regulatory action relating to the OTC derivatives market would destroy the regulatory status quo rather than preserve it. To impose a moratorium on CFTC action while allowing the other agencies to move forward would severely hinder -- not facilitate -- coordination and cooperation among federal financial regulators with respect to the OTC derivatives market.

Proponents of H.R. 4062 have argued that emergency legislation is needed to maintain the status quo in regulation of the OTC derivatives market. As discussed above, there is no emergency: the Commission's Concept Release has not disrupted the market or altered the legal status of any OTC derivative instruments. Furthermore, it is clear that the proposed legislation would profoundly alter the regulatory status quo, not maintain it.

In sum, H.R. 4062 would eviscerate key provisions of the CEA and facilitate transfer of the statutory authority in the CEA to other federal financial regulators whose expertise does not include derivatives market regulation. It purports to enhance legal certainty, but raises more legal questions than it resolves. Most importantly, it would create significant regulatory gaps by tieing the Commission's hands in addressing emergencies and wrongdoing in the market. If Congress wishes to take such actions, it should do so only after careful consideration of the dangers posed by H.R. 4062, not precipitously in response to cries of an emergency for which no evidence has been offered.

VII. Conclusion

Mr. Chairman, I would like to thank you for this opportunity to present the views of the Commission, and I would be happy to answer any questions that the members of the Committee might have.

Attachment 1

that this proposal would not have sufficient federalism implications to warrant the preparation of a Federalism Assessment.

For the reasons discussed above, I certify that this proposed regulation (1) is not a "significant regulatory action" under Executive Order 12866; (2) is not a "significant rule" under the DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979); and (3) if promulgated, will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act. A copy of the draft regulatory evaluation prepared for this action is contained in the Rules Docket. A copy of it may be obtained by contacting the Rules Docket at the location provided under the caption ADDRESSES.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Safety.

The Proposed Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration proposes to amend part 39 of the Federal Aviation Regulations (14 CFR part 39) as follows:

PART 39—AIRWORTHINESS DIRECTIVES

1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

Dornier Luftfahrt GMBH: Docket 98–NM–123–AD.

Applicability: Model 328–100 series airplanes, equipped with nose landing gear (NLG) having serial below IL113; certificated in any category.

Note 1: This AD applies to each airplane identified in the preceding applicability provision, regardless of whether it has been modified, altered, or repaired in the area subject to the requirements of this AD. For airplanes that have been modified, altered, or repaired so that the performance of the requirements of this AD is affected, the owner/operator must request approval for an alternative method of compliance in accordance with paragraph (b) of this AD. The request should include an assessment of the effect of the modification, alteration, or repair on the unsafe condition addressed by this AD; and, if the unsafe condition has not been eliminated, the request should include specific proposed actions to address it.

Compliance: Required as indicated, unless accomplished previously.

To correct cracking in the axle adapter of the shock absorber of the NLG, which could cause failure of the NLG and consequent damage to the airplane structure, accomplish the following:

(a) Within 300 flight hours after the effective date of this AD, perform a one-time visual inspection to detect cracking in the axle adapter of the NLG shock absorber, in accordance with Dornier Service Bulletin SB–328–32–213, dated April 16, 1997.

(1) If no cracking is detected, no further action is required by this AD.

(2) If any cracking is detected, prior to further flight, remove the NLG shock absorber and replace with a new or serviceable part, in accordance with the service bulletin.

Note 2: Dornier Service Bulletin SB–328–32–213, dated April 16, 1997, references Messier-Dowty Service Bulletin 800–32–027, dated May 7, 1997, as an additional source of service information to accomplish the inspection, removal, and repair.

(b) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, International Branch, ANM–116, FAA, Transport Airplane Directorate. Operators shall submit their request through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, International Branch, ANM–116.

Note 3: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the International Branch, ANM–116.

(c) Special flight permits may be issued in accordance with sections 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

Note 4: The subject of this AD is addressed in German airworthiness directive 97–142, dated May 22, 1997.

Issued in Renton, Washington, on May 5, 1998.

John J. Hickey,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 98–12510 Filed 5–11–98; 8:45 am]

BILLING CODE 4910–13–U

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 34 and 35

Over-the-Counter Derivatives

AGENCY: Commodity Futures Trading Commission.

ACTION: Concept Release.

SUMMARY: The Commodity Futures Trading Commission ("CFTC" or "Commission") has been engaged in a comprehensive regulatory reform effort designed to update the agency's oversight of both exchange and off-exchange markets. As part of this reform effort, the Commission is reexamining its approach to the over-the-counter ("OTC") derivatives market.

OTC derivatives are contracts executed outside of the regulated exchange environment whose value depends on (or derives from) the value of an underlying asset, reference rate, or index. They are used by market participants to perform a wide variety of important risk management functions. The CFTC's last major regulatory actions involving OTC derivatives were regulatory exemptions for certain swaps and hybrid instruments adopted in January 1993. Since that time, the OTC derivatives market has grown dramatically in both volume and variety of products offered and has attracted many new end-users of varying degrees of sophistication. The market has also changed, with new products being developed, with some products becoming more standardized, and with systems for central execution or clearing being studied or proposed.

The Commission hopes that the public comments filed in response to this release will constitute an important source of relevant data and analysis that will assist it in determining whether its current regulatory approach continues to be appropriate or requires modification. The Commission wishes to maintain adequate safeguards without impairing the ability of the OTC derivatives market to continue to grow and the ability of U.S. entities to remain competitive in the global financial marketplace. The Commission has identified a broad range of issues and potential approaches in order to generate detailed analysis from commenters. The Commission urges commenters to analyze the benefits and burdens of any potential regulatory modifications in light of current market realities. The Commission has no preconceived result in mind. The Commission is open both to evidence in support of easing current restrictions and evidence indicating a need for additional safeguards. The Commission also welcomes comment on the extent to which certain matters are being or can be adequately addressed through self-regulation, either alone or in conjunction with some level of government oversight, or through the regulatory efforts of other government agencies.

New regulatory restrictions ultimately adopted, if any, will be adopted only after publication for additional public comment and will be applied prospectively only. This release in no

way alters the current status of any instrument or transaction under the Commodity Exchange Act. All currently applicable exemptions, interpretations, and policy statements issued by the Commission regarding OTC derivatives products remain in effect, and market participants may continue to rely upon them.

DATES: Comments must be received on or before July 13, 1998.

ADDRESSES: Comments should be mailed to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581; transmitted by facsimile to (202) 418–5521; or transmitted electronically to {secretary@cftc.gov}. Reference should be made to "Over-the-Counter Derivatives Concept Release."

FOR FURTHER INFORMATION CONTACT: I. Michael Greenberger, Director, David M. Battan, Special Counsel, or John C. Lawton, Associate Director, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street N.W., Washington, D.C. 20581 (202) 418–5430.

SUPPLEMENTARY INFORMATION:

I. Introduction

A. Description of Over-the-Counter Products and Markets

Over-the-counter (OTC) derivatives are contracts executed outside of the regulated exchange environment whose value depends on (or derives from) the value of an underlying asset, reference rate or index.[1] The classes of underlying assets from which a derivative instrument may derive its value include physical commodities (*e.g.*, agricultural products, metals, or petroleum), financial instruments (*e.g.*, debt and interest rate instruments or equity securities), indexes (*e.g.*, based on interest rates or securities prices), foreign currencies, or spreads between the value of such assets.

Like exchange-traded futures and option contracts, OTC derivatives are used to perform a wide variety of important risk management functions. End-users employ OTC derivatives to address risks from volatility in interest rates, foreign exchange rates, commodity prices, and equity prices, among other things. OTC derivative instruments also can be used to assume price risk in order to increase investment yields or to speculate on price changes. Participants in the OTC derivatives market include banks, other financial service providers, commercial corporations, insurance companies, pension funds, colleges and universities, and governmental entities.

Use of OTC derivatives has grown at very substantial rates over the past few years. According to the most recent market survey by the International Swaps and Derivatives Association ("ISDA"), the notional value of new transactions reported by ISDA members in interest rate swaps, currency swaps, and interest rate options during the first half of 1997 increased 46% over the previous six-month period.[2] The notional value of outstanding contracts in these instruments was $28.733 trillion, up 12.9% from year-end 1996, 62.2% from year-end 1995, and 154.2% from year-end 1994.[3] ISDA's 1996 market survey noted that there were 633,316 outstanding contracts in these instruments as of year-end 1996, up 47% from year-end 1995, which in turn represented a 40.7% increase over year-end 1994.[4] An October 1997 report by the General Accounting Office ("GAO") suggests that the market value of those OTC derivatives represents "about 3 percent" of the notional amount.[5] Applying the 3% figure to the most recent ISDA number for contracts outstanding for the first half of 1997 indicates that the world-end market value of these OTC derivatives transactions is over $860 billion.

While OTC derivatives serve important economic functions, these products, like any complex financial instrument, can present significant risks if misused or misunderstood by market participants. A number of large, well publicized, financial losses over the last few years have focused the attention of the financial services industry, its regulators, derivatives end-users, and the general public on potential problems and abuses in the OTC derivatives market.[6] Many of these losses have come to light since the last major regulatory actions by the CFTC involving OTC derivatives, the swaps and hybrid instruments exemptions issued in January 1993.[7]

B. Purpose of This Release

The Commission has been engaged in a comprehensive regulatory reform effort designed to update the agency's oversight of both exchange and off-exchange markets.[8] As part of this process, the Commission believes that it is appropriate to reexamine its regulatory approach to the OTC derivatives market taking into account developments since 1993. The purpose

[1] See Group of Thirty, *Derivatives: Practices and Principles* 2 (1993).

[2] International Swaps and Derivatives Association, Summary of Recent Market Survey Results, ISDA Market Survey, available at (http://www.isda.org).

[3] Id.

[4] Id.

[5] General Accounting Office, GAO/GGD–98–5, OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes 3 n.6 (1997) (hereinafter "1997 GAO Report"). The notional amount represents the amount upon which payments to the parties to a derivatives transaction are based and is the most commonly used measure of outstanding derivatives transactions. Notional amounts generally overstate the amount at risk and the market value of such transactions.

[6] See, e.g., Jerry A. Markham, Commodities Regulation: Fraud, Manipulation & Other Claims, Section 27.05 nn. 2–22.1 (1997) (listing 22 examples of significant losses in financial derivatives transactions); 1997 GAO Report at 4 (stating that the GAO identified 360 substantial end-user losses). Some of these transactions involved instruments that are not subject to the CEA.

[7] Each of these exemptions is discussed in Part II, below.

[8] See, e.g., Proposed Rulemaking Permitting Future-Style Margining of Commodity Options, 62 FR 66569 (Dec. 19, 1997); Concept Release on the Denomination of Customer Funds and the Location of Depositories, 62 FR 67841 (Dec. 30, 1997); Account Identification for Eligible Bunched Orders, 63 FR 695 (Jan. 7, 1998); Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers, 63 FR 2188 (Jan. 14, 1998); Requests for Exemptive, No-Action and Interpretative Letters, 63 FR 3285 (Jan. 22, 1998); Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market, 63 FR 3708 (Jan. 26, 1998); Distribution of Risk Disclosure Statements by Futures Commission Merchants and Introducing Brokers, 63 FR 8566 (Feb. 20, 1998); Amendments to Minimum Financial Requirements for Futures Commission Merchants, 63 FR 12713 (March 16, 1998); Two-Part Documents for Commodity Pools, 63 FR 15112 (March 30, 1998); and Trade Options on the Enumerated Agricultural Commodities, 63 FR 18821 (April 16, 1998). See also Application of FutureCom, Ltd. as a Contract Market in Live Cattle Futures and Options, 62 FR 62566 (Nov. 24, 1997) (Internet-based trading system); Application of Cantor Financial Futures Exchange as a Contract Market in US Treasury Bond, Ten-Year Note, Five-Year Note and Two-Year Note Futures Contracts, 63 FR 5505 (Feb. 3, 1998) (electronic trading system).

of this release is to solicit comments on whether the regulatory structure applicable to OTC derivatives under the Commission's regulations should be modified in any way in light of recent developments in the marketplace and to generate information and data to assist the Commission in assessing this issue.

The market has continued to grow and to evolve in the past five years. As indicated above, volume has increased dramatically. New end-users of varying levels of sophistication have begun to participate in this market. Products have proliferated, with some products becoming increasingly standardized. Systems for centralized execution and clearing are being proposed.

The Commission hopes that the public comments filed in response to this release will constitute an important source of relevant data and analysis that will assist it in determining how best to maintain adequate regulatory safeguards without impairing the ability of the OTC derivatives market to continue to grow and the ability of U.S. entities to remain competitive in the global financial marketplace. The Commission has no preconceived result in mind. The Commission wishes to draw on the knowledge and expertise of a broad spectrum of interested parties including OTC derivatives dealers, end-users of derivatives, other regulatory authorities, and academicians. The Commission urges commenters to provide detail on current custom and practice in the OTC derivatives marketplace in order to assist the Commission in gauging the practical effect of current exemptions and potential modifications.

The Commission is open both to evidence in support or broadening its exemptions and to evidence indicating a need for additional safeguards. Serious consideration will be given to the views of all interested parties before regulatory changes, if any, are proposed. In evaluating the comments and ultimately deciding on its course of action, the Commission will, of course, also engage in its own research and analysis. Any proposed changes will be carefully designed to avoid unduly burdensome or duplicative regulation that might adversely affect the continued vitality of the market and will be published for public comment. Moreover, any changes which impose new regulatory obligations or restrictions will be applied prospectively only.

As this process goes forward, the Commission is mindful of the industry's need to retain flexibility in designing new products as well as the need for legal certainty concerning the enforceability of agreements. Therefore, the Commission wishes to emphasize that, as was the case with other recent concept releases, this release identifies a broad range of issues in order to stimulate public discussion and to elicit informed analysis. This release does not in any way alter the current status of any instrument or transaction under the CEA. All currently applicable exemptions, interpretations, and policy statements issued by the Commission regarding OTC derivatives products remain in effect, and market participants may continue to rely upon them.

II. Current Exemptions [9]

A. Swaps

1. Policy Statement

The Policy Statement was adopted by the Commission on July 21, 1989.[10] It provides a safe harbor from regulation by the Commission under the CEA for qualifying agreements. It addresses only swaps settled in cash, with foreign currencies considered to be cash.[11]

To qualify for a safe harbor from regulation under the Policy Statement, a swap agreement must have all of the following characteristics: (1) individually tailored terms; (2) an absence of exchange-style offset; (3) an absence of a clearing organization or margin system; (4) undertaken in conjunction with a line of business; and (5) not marketed to the general public.

These conditions limit the applicability of the Policy Statement primarily to agreements entered into by institutional and commercial entities such as corporations, commercial and investment banks, thrift institutions, insurance companies, governments and government-sponsored or -chartered entities. The Commission indicated however, that the restrictions did not "preclude dealer transactions in swaps undertaken in conjunction with a line of business, including financial intermediation services." [12] Moreover, the restrictions reflect the Commission's understanding that qualifying transactions will be entered into with the expectation of performance by the counterparties, will be bilaterally negotiated as to material economic terms based upon individualized credit determinations, and will be documented by the parties in an agreement (or series of agreements) that is not standardized.[13] The restrictions are not intended to prevent the use of master agreements between two counterparties, provided that the material terms of the master agreement and the transaction specifications are individually tailored by the parties.[14]

2. Part 35

The Futures Trading Practices Act of 1992 ("1992 Act") [15] added subsections (c) and (d) to section 4 of the Act. Section 4(c)(1) [16] authorizes the Commission, by rule, regulation or order, to exempt any agreement, contract or transaction, or class thereof from the exchange-trading requirements of Section 4(a) or any other requirement of the Act other than Section 2(a)(1)(B). Section 4(c)(2) [17] provides that the Commission may not grant any exemption unless the Commission determines that the transaction will be entered into solely between "appropriate persons." [18] that the exchange trading requirements of Section 4(a) should not be applied, that the agreement, contract or transaction in question will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act, and that the exemption would be consistent with the public interest and the purposes of the Act.

The Commission may grant exemptions "either unconditionally or on stated terms or conditions." [19] Thus,

[9] In addition to the exemptions discussed in the text, the CEA excludes certain transactions. Forward contracts are excluded in section 1a(11) of the CEA, 7 U.S.C. 1A(11). The Treasury Amendment of the CEA excludes "transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgage and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board or trade." Section 2(a)(1)(A)(ii), 7 U.S.C. 2(ii). Furthermore, options on securities or securities indexes are excluded from the Act. Section 2(a)(1)(B)(i), 7 U.S.C. 2a(i). The Commission by order has also exempted certain transactions in energy products from the provisions of the CEA. Exemption for Certain Contracts Involving Energy Products, 58 FR 21286 (April 20, 1993). In addition, the Commission has exempted certain trade options. 17 C.F.R. 32.4; Trade Options on Enumerated Agricultural Commodities, 63 FR 18821 (April 16, 1998). The Commission has also exempted certain transactions in which U.S. customers establish or offset foreign currency options on the Honk Kong Futures Exchange. Petition of the Philadelphia Stock Exchange, Inc. for Exemptive Relief To Permit United States Customers To Establish or Offset Positions in Certain Foreign Currency Options on the Hong Kong Futures Exchange, Ltd. Through Registered Broker-Dealers, 62 FR 15659 (April 2, 1997).

[10] 54 FR 30694 (July 21, 1989).

[11] Id. at 30696.

[12] Id. at 30697.

[13] Id at 30696–97.

[14] See id. at 30696 n. 17.

[15] Pub. L. No. 102–546 (1992), 106 Stat 3590, 3629.

[16] 7 U.S.C. 6(c)(1).

[17] 7 U.S.C. 6(c)(2).

[18] 7 U.S.C. 6(c)(3).

[19] 7 U.S.C. 6(c)(1). Section 4(d), 7 U.S.C. 6(d), provides that

Section 4(c) gives the Commission the authority to tailor its regulatory program to fit the realities of the marketplace and the needs of market participants.

Part 35 of the Commission's regulations exempts swap agreements meeting specified criteria from the provisions of the CEA and the Commission's regulations promulgated thereunder except for the following: Section 2(a)(1)(B) of the CEA;[20] the antifraud provisions set forth in Sections 4b and 4o of the CEA[21] and Commission Rule 32.9;[22] and the antimanipulation provisions set forth in Sections 6(c) and 9(a)(2) of the CEA.[23] The Part 35 swap exemption is retroactive and effective as of October 23, 1974, the date of enactment of the Commodity Futures Trading Commission at of 1974.[24] Part 35 was promulgated under authority granted to the Commission by Section 4(c) of the Act.[25]

To be eligible for exemptive treatment under Part 35, an agreement: (1) must be a swap agreement as defined in Regulation 35.1(b)(1); (2) must be entered into solely between eligible swap participants; (3) must not be a part of a fungible class of agreements that are standardized as to their material economic terms; (4) must include as a material consideration the creditworthiness of a party with an obligation under the agreement; and (5) must not be entered into and traded on or through a multilateral transaction execution facility. These criteria were designed to assure that the exempted swaps agreements met the requirements set forth by Congress in Section 4(c) of the CEA and "to promote domestic and international market stability, reduce market and liquidity risks in financial markets, including those markets (such as futures exchanges) linked to swap markets and eliminate a potential source of systemic risk."[26]

The definition of "swap agreement" provided in Regulation 35.1(b)(1) is as follows:

> Swap agreement means: (i) An agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing); (ii) Any combination of the foregoing; or (iii) A master agreement for any of the foregoing together with all supplements thereto.

This definition is the same as the definition of swap agreement set forth in Section 4(c)(5)(B) of the CEA.[27]

Regulation 35.1(b)(2) defines "eligible swap participant" as follows:

> (i) A bank or trust company (acting on its own behalf or on behalf of another eligible swap participant);
>
> (ii) A savings association or credit union;
>
> (iii) An insurance company;
>
> (iv) An investment company subject to regulation under the Investment Company Act of 1940 . . . or a foreign person performing a similar role or function subject as such to foreign regulation, provided that such investment company or foreign person is not formed solely for the specific purpose of constituting an eligible swap participant;
>
> (v) A commodity pool formed and operated by a person subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, provided that such commodity pool or foreign person is not formed solely for the specific purpose of constituting an eligible swap participant and has total assets exceeding $5,000,000;
>
> (vi) A corporation, partnership, proprietorship, organization, trust, or other entity not formed solely for the specific purpose of constituting an eligible swap participant (A) which has total assets exceeding $10,000,000; or (B) the obligations of which under the swap agreement are guaranteed or otherwise supported by a letter of credit * * * or other agreement by any such entity referenced in this subsection (vi)(A) * * * or * * * in paragraph (i), (ii), (iii), (iv), (v), (vi) or (viii) of this section; or (C) which has a net worth of $1,000,000 and enters into the swap agreement in connection with * * * its business; or which has a net worth of $1,000,000 and enters into the swap agreement to manage the risk of an asset or liability owned or incurred in the conduct of its business or reasonably likely to be owned or incurred in * * * its business;
>
> (vii) An employee benefit plan subject to the Employee Retirement Income Security Act of 1974 or a foreign person performing a similar role or function subject as such to foreign regulation with total assets exceeding $5,000,000, or whose investment decisions are made by a bank, trust company, insurance company, investment adviser subject to regulation under the Investment Advisers Act of 1940 * * * or a commodity trading advisor subject to regulation under the Act;
>
> (viii) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;
>
> (ix) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 * * * or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf or on the behalf of another eligible swap participant: Provided, however, that if such broker-dealer is a natural person or proprietorship, the broker-dealer must also meet the requirements of either subsection (vi) or (xi) of this section;
>
> (x) A futures commission merchant, floor broker, or floor trader subject to regulation under the Act or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf or on behalf of another eligible swap participant: Provided, however, that if such futures commission merchant, floor broker or floor trader is a natural person or proprietorship, the futures commission merchant, floor broker or floor trader must also meet the requirements of subsection (vi) or (xi) of this section; or
>
> (xi) Any natural person with total assets exceeding at least $10,000,000.

The definition of "eligible swap participant" in Regulation 35.1(b)(2) is based on the list of appropriate persons set forth in Section 4(c)(3)(A)–(J) of the CEA. However, the Commission, relying on authority provided in Section 4(c)(3)(K) of the CEA, adjusted those definitions when it adopted Part 35. These adjustments reflected the international character of the swaps market by assuring that both foreign and United States entities could quality for treatment as eligible swap participants. In addition, the Commission raised the threshold for the net worth or total asset test that must be met by certain eligible swap participants. It applied this test as an indication of a swap participant's financial sophistication and background.[28] The Commission indicated its belief that the definition of "eligible swap participant," as adopted, would not adversely affect the swap market as it then existed.[29]

The remaining conditions that must be satisfied by swap agreements in order

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[t]he granting of an exemption under this section shall not affect the authority of the Commission under any other provision of the Act to conduct investigations in order to determine compliance with the requirements or conditions of such exemption or to take enforcement action for any violation of any provision of this Act or any rule, regulation or order thereunder caused by failure to comply with or satisfy such conditions or requirements.

[20] 7 U.S.C. 2a. Section 2(a)(1)(B) of the Act establishes the respective jurisdiction of the CFTC and of the SEC over different instruments and restricts or prohibits certain types of securities futures.

[21] 7 U.S.C. 6b and 6o.

[22] Regulation 32.9, 17 CFR 32.9, prohibits fraud in connection with commodity options transactions.

[23] 7 U.S.C. 9 and 13(a)(2).

[24] Pub. L. No. 93–463 (1974), 88 Stat. 1389. See Commission Regulation 35.1(a) and Exemption for Certain Swap Agreements, 58 FR 5587 at 5588 (January 22, 1993) (adopting Part 35 Rules).

[25] In issuing the swap exemption, the Commission also acted pursuant to its authority to regulate options under Section 4c(b) of the CEA, 7 U.S.C. 6c(b). See Exemption for Certain Swap Agreements, 58 FR 5587 at 5589 (Jan. 22, 1993).

[26] Id. at 5588.

[27] See id. at 5589.

[28] See id. at 5589–90.

[29] See id. at 5590.

to qualify for the Part 35 exemption are meant, among other goals, to assure that the exemption does not permit the establishment of an unregulated exchange-like market in swaps.[30] These conditions require that the creditworthiness of any party having an obligation under the swap agreement must be a material consideration in entering into the agreement and prohibit a swap that is part of a fungible class of agreements, standardized as to their material economic terms, or that is entered into and traded on or through a multilateral transaction execution facility from qualifying for the Part 35 exemption. The Commission has made clear that the Part 35 exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual counterparties to each other is effectively eliminated.[31]

These conditions do not prevent parties who wish to rely on the Part 35 exemption from undertaking bilateral collateral or margining arrangements nor from applying bilateral or multiparty netting arrangements to their transactions, provided however that, in the case of multilateral netting arrangements, the underlying gross obligations among the parties are not extinguished until all netted obligations are fully performed.[32] Nor is the Part 35 restriction on multilateral transaction execution facilities meant to preclude parties who engage in negotiated, bilateral transactions from using computer or other electronic facilities to communicate simultaneously with other participants, so long as they do not use such facilities to enter orders or execute transactions.[33]

Similarly, standardization of terms that are not material economic terms does not necessarily prevent an agreement from qualifying for an exemption under Part 35, provided that the material economic terms of the swap agreement remain subject to individual negotiation by the parties.[34] In this respect, the Commission has explained that:

[T]he phrase "material economic terms" is intended to encompass terms that define the rights and obligations of the parties under the swap agreement, and that as a result, may affect the value of the swap at origination or thereafter. Examples of such terms may include notional amount, amortization, maturity, payment dates, fixed and floating rates or prices (including method by which such rates or prices may be determined), payment computation methodologies, and any rights to adjust any of the foregoing.[35]

B. Hybrid Instruments

1. Background

In 1989, the Commission recognized that certain instruments combined characteristics of securities or bank deposits with characteristics of futures or options and wished to exclude from CEA regulation those hybrid instruments whose commodity-dependent value was less than their commodity-independent value. The Commission issued a Statutory Interpretation Concerning Certain Hybrid Instruments ("Interpretation")[36] which excluded from regulation under the CEA and CFTC regulations debt securities within the meaning of Section 2(1) of the Securities Act of 1933 and time deposits within the meaning of 12 CFR Section 204.2(c)(1) that had the following characteristics: (1) indexation to a commodity on no more than a one-to-one basis; (2) a limited maximum loss; (3) inclusion of a significant commodity component; (4) lack of a severable commodity component; (5) no required delivery of a commodity by means of an instrument specified in the rules of a designated contract market; and (6) no marketing of the instruments as futures contracts or commodity options.[37]

Later in 1989, the Commission adopted Part 34, which exempted certain hybrid instruments with commodity option components from the CEA and from the Commission's regulations.[38] While Part 34 expanded the category of hybrid instruments that were considered to be outside of the CEA and the Commission's regulations, the Commission explicitly stated that it intended not "to address the entire universe of hybrid instruments in the proposed rules, but rather to establish an exemptive framework" that would apply to certain instruments in which issuers had expressed an interest to that point.[39] In 1990, the Commission issued a revised Interpretation designed to conform the Interpretation's treatment of hybrids with the treatment of hybrids in Part 34.[40] The revised Interpretation expanded the class of securities and depository accounts eligible as hybrid instruments and expanded the class of institutions eligible to transact in hybrids.

Congress included a provision in the 1992 Act permitting the Commission to exempt any transaction from all provisions of the CEA except Section 2(a)(1)(B). Using this new authority contained in Section 4(c) of the CEA, the CFTC substantially modified the Part 34 regulations to exempt certain hybrids (including, for the first time, hybrid instruments with futures-like components) from most provisions of the CEA and from the Commission's regulations.

2. Part 34

A hybrid instrument is defined in Part 34 of the Commission's regulations as an equity security, a debt security, or a depository instrument with at least one commodity-dependent component that has a payment feature similar to that of a commodity futures contract, a commodity option contract or a combination thereof.[41] Part 34 exempts such hybrids, and those transacting in and/or providing advice or other services with respect to such hybrids, from all provisions of the CEA except Section 2(a)(1)(B) of the CEA, provided that a number of conditions are met.[42] The conditions include: (1) a requirement that the issuer must receive full payment of the hybrid's purchase price;[43] (2) a prohibition on requiring additional out-of-pocket payments to the issuer during the hybrid's life or at its maturity;[44] (3) a prohibition on marketing the instrument as a futures contract or commodity option;[45] (4) a prohibition on settlement by delivery of an instrument specified as a delivery instrument in the rules of a designated contract market;[46] (5) a requirement that the hybrid be initially sold or issued subject to federal or state securities or banking laws to persons permitted thereunder to purchase the instrument;[47] and (6) a requirement that the sum of the values of the commodity-dependent components of a hybrid instrument be less than the value of the commodity-independent components.[48]

In imposing the first two conditions of Part 34's exemptions—the requirement that the issuer of a hybrid instrument receive full payment of the hybrid's purchase price and the ban on out-of-pocket payments from a hybrid purchaser or holder to the instrument's issuer—the Commission sought to limit the possible losses due to the

[30] See id. at 5590–91.
[31] See id. at 5591.
[32] See id.
[33] See id.
[34] See id. at 5590.
[35] Id. at 5590 n. 24.
[36] 54 FR 1139 (January 11, 1989).
[37] Id.
[38] 54 FR 30684 (July 21, 1989).
[39] Id.
[40] 55 FR 13582 (April 11, 1990).
[41] 17 CFR 34.2(a) (1997).
[42] 17 CFR 34.3(a) (1997).
[43] 17 CFR 34.3(a)(3)(i) (1997).
[44] Id.
[45] 17 CFR 34.3(a)(3)(ii) (1997).
[46] 17 CFR 34.3(a)(3)(iii) (1997).
[47] 17 CFR 34.3(a)(4) (1997).
[48] 17 CFR 34.3(a)(2) (1997).

commodity-dependent components of a hybrid instrument, reasoning that an instrument permitting the accrual of losses in excess of the face value of such instrument is more akin to a position in a commodity derivative than to a debt, equity, or depository instrument.[49] The third condition outlined above, a limitation on marketing the instrument as a futures contract or a commodity option, was intended to prevent purveyors of hybrid instruments from misleading investors as to the nature, legal status and form of regulatory supervision to which such instruments are subject.[50] The Commission did not want potential buyers to believe that hybrids were subject to the full protections of the CEA.

The fourth condition noted above, a prohibition on settlement by a contract market delivery instrument, was designed to guard against interference with deliverable supplies for settlement of exchange-traded futures or options contracts.[51] In adopting the fifth condition, a limitation on persons permitted to purchase an instrument, the Commission was seeking both to address customer protection concerns and Congress's concern, as embodied in Section 4(c)(2)(B)(i) of the CEA,[52] that only transactions entered into between appropriate persons may be exempted from the CEA.[53]

This sixth requirement is referred to as the "predominance test."[54] It was designed in response to authorization granted by Congress in Section 4(c)(5)(A) of the CEA for the Commission to exempt hybrids, which were predominantly securities or depository instruments. The predominance test starts from the premise that hybrid instruments can be viewed as a combination of simpler instruments, the payments on which can be viewed as either commodity-independent or commodity-dependent. The payments on a hybrid's commodity-independent component are not indexed or calculated by reference to the price of an underlying commodity, including any index, spread or basket of commodities; the payments on a hybrid's commodity-dependent component are so indexed or referenced.

For a hybrid instrument to be exempted by Part 34, the present value of the returns associated with the commodity-independent component of an instrument (including any return of principal) must be greater than the "commodity-dependent value" of the instrument. In order to calculate the commodity-dependent value of a hybrid, Part 34 conceptually decomposes a hybrid's commodity-dependent portion into options. The absolute values of the premiums of all implicit options that are at- or out-of-the-money are summed to arrive at the commodity-dependent value of the hybrid instrument.[55] These values are calculated as of the time of issuance of the hybrid instrument.[56]

III. Issues for Comment

A. Background

As the foregoing discussion indicates, the Commission has recognized that differences between exchange-traded markets and the OTC derivatives market warrant differences in regulatory treatment. Pursuant to the exemptions, activity in the OTC derivatives market has generally been limited to decentralized, principal-to-principal transactions between large traders. This has significant regulatory implications.

The OTC derivatives market does not appear to perform the same price discovery function as centralized exchange markets. Accordingly, certain regulatory requirements related to price discovery have not been applied to the OTC derivatives market. Thus, for example, the Commission has not suggested that it should preapprove contract design in the OTC derivatives market as it does for exchanges.

Similarly, the decentralization of trading in the OTC market and the relative sophistication of the participants have meant that issues of financial integrity and customer protection differ from exchange markets. Thus for example, while the Commission has retained its fraud authority for the swap market, it has not required segregation of customer funds.

Developments in the market in the last five years, however, indicate the need to review the current exemptions. As mentioned above, new end-users have entered the market, new products have been developed, some products have become more standardized, and systems for centralized execution and clearing have been proposed. The terms and conditions of the exemptions may need adjustment to reflect changes in the marketplace and to facilitate continued growth and innovation.

In addition, the explosive growth in the OTC market in recent years has been accompanied by an increase in the number and size of losses even among large and sophisticated users which purport to be trying to hedge price risk in the underlying cash markets. Market losses by end-users may lead to allegations of fraud or misrepresentation after they enter transactions they do not fully understand. Moreover, as the use of the market has increased, entities such as pension funds and school districts have been affected by derivatives losses in addition to corporate shareholders.[57]

Accordingly, the Commission believes it is appropriate at this time to consider whether any modifications to the scope or the terms and conditions of the swap and hybrid instrument exemptions are needed to enhance the fairness, financial integrity, and efficiency of this market. The Commission reiterates that the items listed below are intended solely to encourage useful public comment.

The Commission urges commenters to analyze the benefits and burdens of any potential modifications in light of current market realities. In some areas, regulatory relief or expanded access to the market may be warranted while in others additional safeguards may be appropriate. The Commission is especially interested in whether modifications can be designed to stimulate growth. This might be accomplished, for example, by increasing legal certainty and investor confidence, thereby attracting new market participants, or by facilitating netting and other transactional efficiencies, thereby reducing costs. As discussed below, the Commission also welcomes comment on the extent to which certain matters can be adequately addressed through self-regulation. Finally, the Commission invites other regulators to express their views on the issues raised in this release and, in particular, how best to achieve effective coordination among regulators. The Commission anticipates that, where other regulators have adequate programs or standards in place to address

[49] Regulation of Hybrid Instruments, 58 FR 5580 at 5585 (January 22, 1993) (promulgating current Part 34 Rules).

[50] Regulation of Hybrid Instruments, 54 FR 1128 at 1135 (January 11, 1989) (proposing original Part 34 Rules).

[51] 58 FR 5580 at 5582.

[52] 7 U.S.C. 6(c)(2)(B)(i).

[53] 58 FR 5580 at 5585.

[54] 17 CFR 34.3(a)(2) (1997).

[55] More specifically, the absolute net value of all put option premiums with strike prices less than or equal to the reference price would be added to the absolute net value of all call option premiums with strike prices greater than or equal to the reference price. 58 FR 5580 at 5584. "Reference price" is defined in Regulation 34.2(g), 17 CFR 34.2(g), "as the nearest current spot or forward price at which a commodity-dependent payment becomes non-zero, or in the case where two potential reference prices exist, the price that results in the greatest commodity-dependent value."

[56] 58 FR 5580 at 5584–85.

[57] See 1997 GAO Report at 71.

particular areas, the Commission would defer to those regulators in those areas.

B. Potential Changes to Current Exemptions

The exemptions provided by Part 34 and Part 35 reflect circumstances in the relevant market at the time of their adoption. As noted, the Commission believes that it should review these exemptions in light of current market conditions. At the most general level, three issues are presented with respect to these exemptions: first, what criteria should be applied in determining whether a transaction or instrument is eligible for exemption from the CEA; second, what should be the scope of that exemption; and third, what conditions should be imposed, if any, to ensure that the public interest and the policies of the CEA are served.

1. Eligible Transactions

(a) Swaps. Part 35 sets forth certain criteria that an instrument must meet in order to qualify for the swap exemption. These criteria impose restrictions upon the design and execution of transactions that distinguish the exempted swap transactions from exchange-traded products.[58] Given the changes in the swap market since Part 35 was adopted, the Commission seeks comments as to whether the criteria set forth in Part 35 continue to provide a meaningful, objective basis for exempting transactions from provisions of the CEA and CFTC regulations.

In particular, some swap agreements have become highly standardized. The Part 35 exemption does not extend to "fungible agreements, standardized as to their material economic terms." The Commission seeks comment on whether this part of the Part 35 criteria provides sufficient guidance for parties involved in swaps. Parties may have difficulty in readily assessing whether a particular transaction qualifies for treatment under the Part 35 exemption.

In order to provide greater clarity, the Commission could adopt additional or alternative requirements governing exempted swap agreements. For example, the Commission could provide additional detail concerning the concept of fungibility in this context. The Commission could also clearly specify which terms of an agreement would be considered to be material economic terms under Part 35.

Moreover, subject to consideration of the requirements set forth in Sections 4(c)(1) and (c)(2) of the CEA, the Commission could consider expanding the scope of the swap exemption so that it more clearly applies to certain classes of transactions that exhibit some degree of standardization. In this regard, while Section 4(c)(5)(B) authorizes the Commission to exempt non-fungible swaps, the lack of fungibility is not a necessary criterion under Sections 4(c)(1) or (c)(2) for exercising exemptive authority.

Request for comment. The Commission requests comment on whether the swaps exemption should be extended to fungible instruments and, if so, under what circumstances. The Commission is also seeking more general comment as to whether the swaps exemption continues to fulfill its stated goals. In this regard, the Commission is interested in commenters' views on what changes in the current rules may be needed to assure that Part 35 provides legal certainty to the current market and fulfills the statutory goals set forth in Section 4(c) of the CEA.

In particular, the Commission requests comment on the following questions.

1. In what ways has the swap market changed since the Commission adopted Part 35. Please address:
(a) the nature of the products;
(b) the nature of the participants, both dealers and end-users;
(c) the location of transactions;
(d) the business structure of participants (e.g., the use of affiliates for transacting OTC derivatives);
(e) the nature of counterparty relationships;
(f) the mechanics of execution;
(g) the methods for securing obligations; and
(h) the impact of the current regulatory structure on any of the foregoing.

2. What are the mechanisms for disseminating the prices for swap transactions?

3. Does the swap market serve as a vehicle for price discovery in underlying cash markets? If so, how? Please describe.

4. To what extent is the swap market used for hedging? To what extent is it used for speculation? Please provide details.

5. Is there a potential for transactions in the swap market to be used to manipulate commodity prices? Please explain.

6. To what degree is the swap market intermediated, i.e., to what extent do entities
(a) act as brokers bringing end-users together?
(b) act as dealers making markets in products?
Please describe the intermediaries in the market and the extent and nature of their activities.

7. To what extent do swap market participants act in more than one capacity (e.g., as principal in some transactions and broker in others)?

8. In light of current market conditions, do the existing Part 35 requirements provide reasonable, objective criteria for determining whether particular swaps transactions are exempted under the CEA? Should the meaning of terms such as "fungible," "material economic terms," or "material consideration" be clarified or modified in any way? If so, how?

9. What steps can the Commission take to promote greater legal certainty in the swap market?

10. What types of documentation are relevant in determining whether a particular transactions falls within the swaps exemption and/or the Policy Statement? Should the Commission set standards in this regard?

11. If the current restrictions set forth in the Part 35 requirements negatively affect or potentially limit the OTC market or its development in the United States, what changes would alleviate the negative effects? Should the exemption in Part 35 be broadened in any manner?

12. What steps, if any, can the Commission take to promote greater efficiency in the swap market, such as for example, by facilitating netting?

13. Are any changes in regulation relating to the design or execution of exempted swap transactions needed to protect the interests of end-users in the swap market? Are there changes in regulation that would attract new end-users to the market or lead existing end-users to increase their participation?

14. Should distinctions be made between swaps that are cash-settled and swaps that provide for physical delivery? Please explain.

15. Should transactions in fungible instruments be permitted under the swaps exemption?

16. To what extent should the creditworthiness of a counterparty continue to be required to be a material consideration under the swaps exemption? Please explain.

(b) Hybrid instruments. Part 34 was designed to exempt from Commission regulation instruments in which the commodity futures or option characteristics were subordinate to their characteristics as securities and deposits. Some experienced practitioners have stated that the definition of a hybrid instrument under Part 34 is extremely complex and difficult to understand and to apply. Moreover, the Commission staff has

[58] CFTC, OTC Derivatives Markets and Their Regulation 78–79 (1993) ("CFTC OTC Derivatives Report") (discussing swaps exemption).

recently reviewed several hybrid instruments that had very significant commodity components yet were apparently eligible for exemption under Part 34's technical definition.

For example, the Commission staff recently reviewed an instrument structured as a medium-term debt instrument paying a small quarterly coupon rate. At maturity, after subtracting out a "factor" reflecting certain costs borne by the issuer, the purchaser would receive a payment that was based on the performance of an index of futures contract prices with no upward limit on the commodity-based return. Moreover, the holder could lose its entire investment based on a downward movement in the commodity index. Commission staff believed that, under Part 34 as currently written, the instrument apparently would be exempt from regulation under the CEA. A regulatory definition that treats the entire principal as "commodity independent" despite the fact that all of the principal on this instrument could be lost as a direct result of movement in the commodity index warrants additional analysis.

Another conceptual concern with the current definition is the manner in which it assigns value to the "commodity dependent" component. Futures-like elements are analyzed as a combination of offsetting at-the-money puts and calls. The sum of the absolute values of these option premiums is the assigned value of the futures-like component. Some observers have suggested that this test is not an appropriate measure of the commodity dependent value. As Part 34 is currently structured, whether or not an instrument qualifies for an exemption depends critically on the total volatility of the commodity-dependent portion. This creates three potential problems. First, the technical knowledge needed to identify the commodity-dependent volatility may be a challenge for some market participants. Second, for two instruments that are identical except for their commodity-dependent volatility, one might be classified as exempt while the other might not. Indeed, if the volatility of the underlying commodity changes through time, the classification of identical hybrid instruments issued on different dates might be different. Thus, Part 34 may create some undesirable ambiguity regarding which instruments qualify for an exemption. Third, it appears to be paradoxical that short-term instruments are more likely to be classified as exempt than long-term instruments even though short-term instruments generally are more akin to exchange-traded futures in many respects.

If the Commission were to modify or to clarify the predominance test in a way that resulted in more instruments being found to have a predominant commodity-dependent component, the Commission could exercise its authority under Section 4(c) to exempt some or all of such instruments subject to specified terms and conditions. As is the case today, instruments in which the commodity-independent component was predominant would not be subject to any such terms and conditions.

Request for comment. The Commission requests comment on the foregoing analysis. It welcomes alternative suggestions for analyzing hybrid instruments and for simplifying the definition of exempt hybrid instruments.

17. In what ways has the hybrid instrument market changed since the Commission adopted Part 34? Please address:

(a) the nature of the products;

(b) the nature of the participants, both dealers and end-users;

(c) the location of transactions;

(d) the nature of the counterparty relationships;

(e) the mechanics of execution;

(f) the methods for securing obligations; and

(g) the impact of the current regulatory structure on any of the foregoing.

18. What are the mechanisms for disseminating prices for hybrid instrument transactions?

19. Does the hybrid instrument market serve as a vehicle for price discovery in underlying commodities? If so, how? Please describe.

20. To what extent is the hybrid instrument market used for hedging? To what extent is it used for speculation? Please provide details.

21. Is there a potential for transactions in the hybrid instrument market to be used to manipulate commodity prices? Please explain.

22. To what degree is the hybrid instrument market intermediated, i.e., to what extent do entities

(a) act as brokers bringing end-users together?

(b) act as dealers making markets in products?

Please describe the intermediaries in the market and the extent and nature of their activities and the extent to which transactions in these instruments are subject to other regulatory regimes.

23. To what extent do hybrid instrument market participants act in more than one capacity (e.g., as a principal in some transactions and broker in others)?

24. In light of current market conditions, do the existing Part 34 requirements provide reasonable, objective criteria for determining whether a particular hybrid instrument performs the functions of a futures or option or those of a security or depository instrument? Are the criteria easily understood and applied by participants in the market? Do they properly distinguish types of instruments? If not, should they be changed? How?

25. What steps, if any, can the Commission take to promote greater legal certainty in the hybrid instrument market? Please explain.

26. Should Part 34 be amended to reflect more accurately or more simply whether commodity-dependent components predominate over commodity-independent components?

27. Are changes in regulation relating to the design or execution of transactions in exempted hybrid instruments needed to protect the interests of end-users in the hybrid instrument market? Are there changes in regulation that would attract new end-users to the market or lead existing end-users to increase their participation?

28. Should the Commission exercise its authority to exempt any hybrid instruments with a predominant commodity component subject to specified terms and conditions? Please explain.

2. Eligible Participants

Section 4(c)(2) states that "the Commission shall not grant any exemption under" authority granted therein "unless the Commission determines that . . . the agreement, contract or transaction will be entered into solely between appropriate persons." Section 4(c)(3) further states that "the term 'appropriate person' shall be limited" to the classes of persons specifically listed therein including "[s]uch other persons that the Commission determines to be appropriate in light of their financial or other qualifications or the applicability of appropriate regulatory protections."

(a) Swaps. Part 35 currently contains a requirement that an exempt swap agreement be between eligible swap participants, as defined in Regulation 35.1(b)(2). The list of eligible swap participants in Part 35 is based substantially on the list of "appropriate person" defined in the CEA. The Commission seeks comments as to whether the current list of eligible swap participants should be modified in any way. The Commission requests comment regarding whether the definition is adversely affecting the

swaps market by excluding persons who should be included or, alternatively, by including persons who are not, or should not be, active in the current market. The Commission also seeks comment on whether additional persons should be added and, if so, whether additional protections would be appropriate. In either case, commenters are asked to describe such persons and the protections they need, if any.

Any potential change must be analyzed in light of the stated Congressional intent that any exempted transaction must be entered into solely by appropriate persons as defined in Section 4(c)(3)(A)–(K) of the Act. In addition, any changes to the definition of eligible swap participant would be considered in light of any other relevant changes that may result from Commission follow-up to this concept release.

(b) Hybrid instruments. As discussed above, if the Commission were to modify the predominance test under Part 34, it might also decide to exempt certain commodity-like hybrid instruments subject to specified terms and conditions. The Commission invites analysis on the potential applicability of an appropriate person standard in that context.

Request for comment. 29. Should the current list of eligible swap participants be expanded in any way? Should it be contracted in any way? If so, how and why?

30. Are there currently eligible swap participants who would benefit from additional protections? Are there potential swap participants who are not currently eligible but would be appropriate subject to additional protections? In either case, please describe the types of persons and the types of protections.

31. Should the Commission establish a class of eligible participants for the trading of hybrid instruments with a predominant commodity-dependent component? If so, please describe.

32. Is it advisable to use a single definition of sophisticated investor whenever that concept arises under the Commission's regulations? If so, what definition should apply?

3. Clearing

Clearing of swaps is not permitted under Part 35. The Commission expressly stated that:

> The exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual members of the system to each other in a transaction to which each is a counterparty is effectively eliminated and replaced by a system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction.[59]

Regulation 35.2 provides, however, that "any person may apply to the Commission for exemption from any of the provisions of the Act (except 2(a)(1)(B)) for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate. * * *" The Commission included this proviso in order to hold open the possibility that swap agreements cleared through an organized clearing facility could be exempted from requirements of the Act under appropriate terms and conditions. The Commission affirmatively stated that the proviso "reflects the Commission's determination to encourage innovation in developing the most efficient and effective types of systemic risk reduction" and that "a clearing house system for swap agreements could be beneficial to participants and the public generally."[60]

In the years since Part 35 was issued, interest in developing clearing mechanisms for swaps and other OTC derivatives has increased. The Commission has had extensive discussions with several organizations engaged in designing clearing facilities.[61] The Commission believes that these efforts have reached a stage where it is necessary to consider and to formulate a program for appropriate oversight and exemption of swaps clearing.

Clearing organizations can provide many benefits to participants, such as the reduction of counterparty credit risk, the reduction of transaction and administrative costs, and an increase in liquidity. They also can provide benefits to the public at large by increasing transparency. These benefits are obtained at the cost of concentrating risk in the clearing organization. Accordingly, a greater need may exist for oversight of the operations of a clearing organization than for any single participant in an uncleared market.

In the 1993 CFTC OTC Derivatives Report, the Commission stated that the regulatory issues presented by a facility for clearing swaps "would depend materially upon the facility's design, such as, for example, the extent to which the construction of such a facility is consistent with the minimum standards for netting systems recommended by the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (Lamfalussy Report)."[62] Comment is requested concerning the usefulness of the Lamfalussy standards in this context.

The Commission has identified the following core elements that should be addressed: the functions that an OTC derivatives clearing facility would perform; the products it would clear; the standards it would impose on participants; and the risk management tools it would employ. As discussed below, the Commission invites comments on each of these topics.

(a) Functions. An OTC derivatives clearing facility could perform a variety of functions ranging from simple trade comparison and recordation to netting of obligations to the guarantee of performance. For example, the Commission notes that, in jurisdictions other than the U.S., there may not be a clearing guarantee, or the guarantee may attach at a time other than the initiation of the trade. The Commission requests comment on which of these functions, if any, should be permitted and under what circumstances.

(b) Products cleared. The definition of the term "swap agreement" in Regulation 35.1(b)(1) is very broad. Financial engineers are continually designing new products that fall within that definition but have novel characteristics. As a practical matter, the Commission believes that any OTC derivatives clearing facility would be most likely in the context of "plain vanilla" products for which prices can be readily established and for which there is some standardization as to

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[59] 54 FR 5587 at 5591.

[60] Id. at 5591 n.30.

[61] Not all the proposed arrangements have included the mutualization of risks among members of a clearing organization. In some cases, a single entity proposed to support the clearing arrangements using its own assets.

[62] CFTC OTC Derivatives Report at 136–37. The Lamfalussy standards are the following:

1. Netting schemes should have a well-founded legal basis under all relevant jurisdictions;

2. Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process;

3. Multilateral netting systems should have clearly-defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant.

4. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position;

5. Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access; and

6. All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements.

terms. The Commission requests comment on whether the range of products that may be cleared through an OTC derivative clearing facility, or their terms of settlement, should be limited in any way.

(c) Admission standards. The class of eligible swap participants ias defined in Regulation 35.1(b)(2). There is an inherent tension between the desire to promote open and competitive markets by allowing access.[63] and the desire to maintain financial integrity by imposing admission standards. The Commission requests comment on what standards, if any, it should establish, or permit an OTC derivatives clearing facility to establish, for admission as a clearing participant. Comment is also requested on whether clearing should be limited to transactions undertaken on a principal-to-principal basis or whether agency transactions should be included.[64]

(d) Risk management tools. An OTC derivatives clearing facility could choose from among many potential risk management tools. These include capital requirements for participants, reporting requirements, position or exposure limits, collateral requirements, segregation requirements, mark-to-market or other valuation procedures, risk modeling programs, auditing procedures, and information-sharing arrangements. The clearing facility could also draw upon its own capital, its lines of credit, any guarantee funds financed by clearing members, or other arrangements for sharing losses among participants. The relevance of these various items would depend, of course, on the functions the clearing facility performed and the products its cleared. The Commission requests comment on how best to assure that a clearing facility uses appropriate risk management tools without preventing flexibility in the design of such tools or inhibiting the evolution of new risk management technology.

(e) Other considerations. Permitting OTC products to be cleared may make them more like exchange-traded products. The Commission welcomes comment on how best to promote fair competition and even-handed regulation in the context of the clearance of OTC derivative products.

In approving Part 35, the Commission noted that it was "mindful of the costs of duplicative regulation [65] and added the proviso to Regulation 35.2 that the Commission would consider "the applicability of other regulatory regimes" in addressing petitions for further exemptive relief relating to swaps facilities. The Commission recognizes that existing clearing facilities that are regulated by another federal regulatory authority because the clear products subject to that regulator's jurisdiction may wish to develop swap clearing facilities. The Commission requests comment on how to address this situation.

Request for comment. 33. Are any swaps currently subject to any type of clearing function, either in the U.S. or abroad? If so, please provide details.

34. Would permitting swap clearing facilities promote market growth and assist U.S. participants in remaining competitive? If so, please describe the appropriate elements of a program for the oversight of swap clearing organizations.

35. Should there be a limit on the clearing functions permitted for swaps?

36. Should there be a limit on the range of products that may be cleared through a swap clearing facility?

37. Should there be standards for admission as a clearing participant?

38. What types of risk management tools should a clearing facility employ?

39. To what degree would cleared swaps be similar to exchange traded products? How best can the Commisison promote fair competition and even-handed regulation in this context?

40. How should the Commission address OTC derivative clearing facilities that are subject to another regulatory authority by virtue of conducting activities subject to that regulator's jurisdiction?

4. Transaction Execution Facilities

Regulation 35.2(d) provides that a swap agreement may not be entered into or traded on or through a multilateral transaction execution facility ("MTEF").[66] In the release issuing Part 35, the Commission described an MTEF as:

> [A] physical or electronic facility in which all market makers and other participants that are members simultaneously have the ability to execute transactions and bind both parties by accepting offers which are made by one member and open to all members of the facility.[67]

The Commission specified that the MTEF limitation did not:

> [P]reclude participants from engaging in privately negotiated bilateral transactions, even where these participants use computer or other electronic facilities, such as "broker screens," to communicate simultaneously with other participants so long as they do not use such systems to enter orders to execute transactions.[68]

The Commission noted that there were no swap MTEFs in existence at that time.[69] Consistent with the proviso in Regulation 35.2, the Commission invited application for appropriate exemptive relief for such facilities as they were developed.[70]

The Commission is requesting comment on whether the regulatory approach to execution facilities should be modified in any way. Specifically, the Commission invites comment on whether the description of MTEFs set forth above is sufficiently clear, whether it accurately delineates the relevant features, and how the Commission should address other types of entities that facilitate execution, such as market makers or bulletin board services. The Commission recognized when it promulgated Part 35 that MTEFs "could provide important benefits in terms of increased liquidity and price transparency." [71] The Commission seeks comment on whether it should permit swaps to be traded through an MTEF or other similar facilities and, if so, what terms and conditions should be applied. It also seeks comment on the degree to which such trading would be similar to exchange trading and the degree to which similar safeguards are needed. As in the case of clearing facilities, the Commission is mindful of the need to promote fair competition between and even-handed regulation of exchanges and the swap market.

Part 36 of the Commission's regulations [72] was designed to allow reduced regulation for exchange trading limited to sophisticated traders. It was intended to "permit * * * exchange-traded products greater flexibility in competing with foreign exchange-traded products and with both foreign and domestic over-the-counter transactions while maintaining basic customer protection, financial integrity and other protections associated with trading in an exchange environment." [73] No contract market has applied for exemption under Part 36. An analysis of the perceived strengths and weaknesses of Part 36 may be a useful starting point in determining an appropriate regulatory regime for execution facilities. Accordingly, the Commission requests comment on whether elements

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[63] See Section 15 of the Act, 7 U.S.C. 19.

[64] Current Part 35 allows only certain eligible swap participants to act on the behalf of another eligible swap participant. See 17 CFR 35.1(b)(2) (1997).

[65] 58 FR 5587 at 5591 n.30.

[66] 17 CFR 35.2(d) (1997).

[67] 58 FR 5587 at 5591.

[68] Id.

[69] Id.

[70] Id.

[71] Id.

[72] 17 CFR 36.1–36.9 (1997).

[73] Section 4(c) Contract Market Transactions, 60 FR 51323 (Oct. 2, 1995).

of Part 36 should be applicable to execution facilities. Proposals for modification of Part 36 are welcome.

Request for comment. 41. Should the definition of MTEF be changed in any way to provide more clarity?

42. Are MTEFs or other types of execution facilities currently being used for swap trading, either in the U.S. or abroad? If so, please provide details.

43. What terms and conditions, if any, should be applied to execution facilities? Please address potential competitive effects on current exchange trading and the degree to which similar requirements should be made applicable. Please also address the strengths and weaknesses of current Part 36 for this purpose.

5. Registration

Registration has been called "the kingpin in [the CEA's] statutory machinery, giving the Commission the information about participants in commodity trading which it so vitally requires to carry out its other statutory functions of monitoring and enforcing the Act.[74] Registration identifies participants in the markets and allows for a "screening" process by requiring applicants to meet fitness standards. Registration may also facilitate enforcement of fraud prohibitions. In addition, the requirement to register may trigger other standards and obligations for registrants under the CEA and Commission rules.[75] Part 34 and Part 35 of the Commission's regulations currently exempt parties from the registration requirements of the Act with respect to qualifying transactions.

The Commission seeks comment on whether registration requirements for dealers or intermediaries would be useful or necessary for the Commission in its oversight of the OTC derivatives market. Registration would identify key players in the OTC derivatives markets but would not necessarily trigger the full range of regulations applicable to registered persons involved in exchange-traded futures and options. Instead it could be related to separate and limited OTC derivatives market regulations. Alternatively, the Commission seeks comment on whether it would be appropriate to adopt a notice filing, requiring parties involved in certain activities within the OTC derivatives markets to identify themselves to the Commission.

In addressing this issue, commenters should consider, among other things, whether a distinction should be made between swaps and hybrid instruments. Comment also would be useful on whether it would be sufficient that a person is registered or regulated by another federal agency so that the Commission should waive any registration requirements for such persons with respect to OTC derivatives transactions.

Differences between the OTC derivative market and exchange-traded futures and option markets may affect the need for registration in the context of OTC derivatives trading. For example, since swap transactions occur among institutional participants who bilaterally negotiate an agreement, there may be reduced value added in requiring dealers or advisors to undergo fitness checks. Such institutional participants would likely have the resources to investigate the fitness of potential counterparties and advisors.

Request for comment. 44. What benefits might arise from requiring registration of dealers, intermediaries, advisors, or others involved in OTC derivative transactions? Should any requirement be in the form of a notice filing or full registration?

45. What criteria should be used in determining the types of transactions and the types of market participants subject to registration requirements?

46. Should regulation by other federal agencies be a factor in permitting an exemption from registration or notice filing?

47. What role should membership in a designated self-regulatory organization play?

6. Capital

Capital requirements have long been considered important for assuring a firm's ability to perform its obligations to its customers and to its counterparties and for controlling systemic risk. The Commission currently imposes no capital requirements on participants in the OTC derivatives markets. Given the sophistication of the participants, the generally principal-to-principal nature of their relationships with one another, the fact that OTC derivatives dealers typically do not hold customer's funds in an agency relationship (in contrast to futures commission merchants or broker-dealers), and the applicability of other regulatory capital standards to many market participants, capital requirements may be unnecessary.

The Commission seeks to explore whether regulatory capital might serve a useful function in the context of the OTC derivatives markets. For example, regulatory capital might provide an OTC derivatives dealer's counterparties with independent assurance of the creditworthiness of the dealer or might prevent the dealer from assuming excessive leverage. Capital requirements might also serve the function of providing early warning of financial difficulties.

Request for comment. 48. Are any capital requirements for OTC derivatives dealers needed? Why? What benefits would they provide to the market? What burdens would they impose?

49. Should any reporting or disclosure requirements be established for dealers as an alternative to capital requirements in order to permit counterparties to evaluate their creditworthiness adequately? Please explain.

50. Do ratings by nationally recognized statistical rating organizations fulfill the function of assuring end-user counterparties of the creditworthiness of OTC derivatives dealers?

7. Internal Controls

The importance of internal controls for financial services firms generally and for derivatives dealers in particular is widely recognized.[76] The Commission has long required information concerning risk management and internal control systems from FCMs, as well as prompt reporting of any material inadequacies in such systems.[77] Close attention to risk management and internal control systems may be especially important in an environment where capital standards (whether imposed by regulators or internally) are reduced and are based on the results of internal value-at-risk models and calculations rather than on more standardized "haircuts." While a

[74] *Commodity Futures Trading Commission* v. *British American Commodity Options Corp.*, 560 F.2d 135 at 139–40 (2d Cir. 1977) *cert. denied*, 438 U.S. 905 (1978).

[75] *See, e.g.*, Sections 8a(2) and 8a(3) of the Act (statutory disqualification) and Regulation 1.12 (requirement that registered futures commission merchants ("FCMs") and registered introducing brokers ("IBs"), or any person who files an application to be so registered, notify the Commission if its capital falls below minimum capital requirements); Regulation 1.15 (risk assessment reporting for registered FCMs); Regulation 1.17 (minimum capital requirements for registered FCMs and registered IBs); Regulation 4.21 (requirement that commodity pool operators ("CPOs") who are registered or required to be registered deliver a disclosure document to clients or potential clients). Other regulations, however, may be applicable to parties whether or not they are registered or required to be registered. *See, e.g.*, Part 189 (large trader reporting requirements).

[76] See, e.g., DPG Framework at 13–22; IOSCO, The Implications for Securities Regulators of the Increased use of Value at Risk Models by Securities Firms, Section 2 (Jul. 1995); Basle Committee on Banking Supervision, Framework for the Evaluation of Internal Control Systems at 1 (Jan. 1998); Group of Thirty, Derivatives: Practices and Principles at 2 (1993).

[77] See, e.g., Regulations 1.14(a)(1)(ii); 1.15(a)(1)(ii); 1.16(e)(2).

complete discussion of internal control programs is beyond the scope of this release, the following elements of such a program are generally considered particularly important: effective models for measuring market and credit risk exposure; careful procedures for continuously validating those models, including rigorous backtesting and stress testing; netting arrangements that are enforceable in the relevant jurisdictions (and programs to review their enforceability on a regular basis); and a risk monitoring unit which reports directly to senior management, is independent of the business units being monitored, and has the necessary training and resources to accomplish its control objectives.

Request for comment. 51. Would OTC derivatives market participants benefit from internal control guidelines? If so, what market participants should be covered?

52. What provisions should be included in internal control requirements, if any?

53. How should compliance with any internal control requirements be monitored (e.g., regular audits, periodic spot checks, required reports)?

54. Who should be responsible for monitoring compliance with any internal control requirements (e.g., regulatory agencies, SROs, independent auditors)?

55. Could and should internal control standards serve as a substitute for regulatory capital requirements?

8. Sales Practices

As noted in the Introduction, a significant number of participants in the OTC derivatives markets have experienced large financial losses since the Commission's last regulatory initiatives involving OTC derivatives. The 1997 GAO Report notes that "[s]ales practice concerns were raised in 209, or 58 percent, of [the] losses [reviewed in the Report] and were associated with an estimated $3.2 billion in losses." [78] Size and sophistication of a market participant may not provide meaningful protection against sales practice concerns, such as fraud.

The parties to OTC derivatives transactions are commonly referred to as end-users and dealers.[79] End-users and OTC derivatives dealers may have differing views concerning the respective responsibilities of the parties to an OTC derivatives transaction. According to a survey undertaken in conjunction with the GAO Report, "about one-half of all end-users of plain vanilla or more complex OTC derivatives believed that a fiduciary relationship of some sort existed in some or all transactions between them and their dealer." [80] By contrast, "two dealer groups issued guidance asserting that such transactions are conducted on a principal-to-principal, or an 'arm's-length,' basis unless more specific responsibilities are agreed to in writing or otherwise provided by law." [81] These differences in view can create problems, especially because of the extraordinary complexity of some OTC derivatives instruments and the information disparity between a derivatives dealer and many end-users. Therefore, comments concerning whether there is a need for sales practice rules applicable to OTC derivatives dealers would be useful.

In granting the Part 35 swaps exemption, the Commission retained the applicability of its basic antifraud and antimanipulation authority.[82] In addition, some OTC derivatives transactions are subject to sales practice standards administered by other financial regulatory agencies. For example, both the Office of the Comptroller of the Currency and the Federal Reserve Board have issued guidance addressing sales practice issues in the context of a bank's overall responsibilities for managing the risks of its financial activities, including OTC derivatives.[83]

The Commission seeks comments concerning potential sales practice standards for principal-to-principal transactions between dealers and end-users. The Commission would also welcome information from commenters concerning the volume of transactions, if any, in which dealers act strictly as agents, rather than principals, in facilitating transactions between two end-users and whether any specific sales practice rules should apply to such agency transactions. Likewise, the Commission would welcome comments on the volume of transactions in which dealers trade directly with other dealers for their own proprietary accounts and whether any specific sales practice rules should apply to those dealer-to-dealer transactions.

(a) Disclosure. Traditionally, the most fundamental regulatory protection in the area of sales practices has been the duty to disclose risks and other material information concerning transactions to potential customers. Disclosure concerns have often been raised with respect to OTC derivatives transactions. For example, the DPG Framework, in its section on counterparty relationships, states that dealers should consider providing new end-users with "[g]eneric [r]isk [d]isclosure," which it characterizes as "disclosure statements generally identifying the principal risks associated with OTC derivatives transactions and clarifying the nature of the relationship between the [dealer] and its counterparties." [84] This section of the DPG Framework goes on to provide additional details on the nature of the relationship to be clarified, stating the DPG's view that "OTC derivatives transactions are predominantly arm's-length transactions in which each counterparty has a responsibility to review and evaluate the terms and conditions, and the potential risks and benefits, of prospective transactions * * *." [85] However, the DPG Framework provides no further guidance as the nature or content of the generic risk disclosure.[86] Comment is

[78] 1997 GAO Report at 71.

[79] By "end-users" the Commission is referring generally to participants who use derivatives to manage financial risks and opportunities that arise in the course of their businesses. Dealers are distinguished from end-users by their willingness to make two-way markets in OTC derivatives, either for end-users or for other dealers. *See* however, Derivatives Policy Group, Framework for Voluntary Oversight (Mar. 1995) ("DPG Framework") (the Framework was developed by a group of six major investment firms). The DPG Framework refers to dealers as "professional intermediaries" and to end-users as "nonprofessional counterparties." This difference in articulation is symptomatic of the differing views that sometimes exist among the participants in these markets concerning their respective roles.

[80] 1997 GAO Report at 5.

[81] *Id. See DPG Framework* at 9; and Federal Reserve Bank of New York, Principles and Practices for Wholesale Financial Market Transactions 1 (Aug. 17, 1995) (the Principles and Practices were developed by a group of six financial industry trade associations in coordination with the Federal Reserve Bank of New York).

[82] *See* 17 CFR 35.2 (1997).

[83] *See, e.g.*, OCC, Banking Circular 277: Risk Management of Financial Derivatives, BC-277, 1993 WL 640326 (OCC) (Oct. 23, 1993); OCC Bulletin, Questions and Answers Re: BCC 277, OCC 94-31, 1994 WL 194290 (OCC) (May 10, 1994); and Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations, [SR 93-69 (FIS)], (Dec. 20, 1993). These are not sales practice standards in the usual sense but bank risk management standards.

[84] DPG Framework at 37. The 1997 GAO Report recommends that the CFTC and SEC establish a mechanism for determining that the DPG firms are, in fact, following this and other sales practice standards in the DPG Framework.

[85] Id.

[86] The section of the DPG Framework on risk management controls lists five basic risks of OTC derivative transactions: market risk, credit risk, liquidity risk, legal risk, and operational risk. *Id.* at 14-15. In addition to these firm-specific risks, the CFTC OTC Derivatives Report lists a number of potential risks arising from OTC derivatives activities generally, including the complexity of the derivatives marketplace, the fact that dealer activity tends to be concentrated in a relatively small number of large entities, the lack of transparency,

Continued

solicited on whether risk disclosure should be required and, if so, the nature and content of such disclosure.

(b) Customer information. Comment is also solicited on whether it would be appropriate to require the dealer to obtain certain information from the end-user. Such information might include, for example:

- net worth information;
- information confirming that the end-user is within the class of eligible participants set out in Section 35.1 of the Commission's regulations;[87] or
- information demonstrating that the end-user is authorized to enter into the transaction.

(c) Other possible sales practice rules. Potential sales practice rules might also include provisions requiring dealers to supervise sales personnel and other employees responsible for handling the accounts of end-user customers. One element of such supervision might be to ensure that sales personnel are properly trained.

The Commission also wishes to consider what regime, if any, would be appropriate for overseeing the implementation and enforcement of any sales practice rules for OTC derivatives, including the costs and benefits of alternative oversight mechanisms. In that context, the Commission is seeking comments on: (1) the appropriate direct regulatory role of the CFTC with respect to potential sales practice rules; (2) the appropriate regulatory role of other financial regulatory agencies, including the applicability of any sales practice rules administered by other agencies and the degree of deference that should be accorded to such rules; and (3) the appropriate sales practice role of industry self-regulatory bodies, including the degree of CFTC oversight necessary to assure that any industry self-regulatory standards are properly implemented and enforced.

Request for comment. 56. Since Part 35 was adopted, has the swap market experienced significant problems concerning fraud or sales practice abuses? Since Part 34 was adopted, has the hybrid instrument market experienced significant problems concerning fraud or sales practice abuses? If so, please describe.

57. Is there a need for any sales practice rules in the OTC derivatives market? If so, what should the rules provide, and to whom and under what circumstances should they be applicable?

58. Is there a need for risk disclosures by OTC derivatives dealers to end-users? If so, what risks should be disclosed?

59. Should OTC derivatives dealers be required to supplement any required generic risk disclosure statement with additional firm- or transaction-specific disclosures? If so, what should such disclosures cover?

60. What kind of disclosures, if any, should dealers make to end-users clarifying the nature of the relationship between the parties? Should there be rules establishing duties of the OTC derivatives dealer to its customers, and if so, what should they require?

61. What kind of disclosures, if any, should dealers make concerning the material terms of OTC derivatives contracts, including methods for calculating price, value, profit and loss, as well as the amount of commissions, fees and other costs involved?

62. What other kinds of disclosures, if any, might be appropriate concerning, for example, potential conflicts of interest, the dealer's policies on helping end-users to unwind transactions and matters such as the dealer's financial soundness, experience, or track record?

63. Should dealers be required to make periodic status reports to end-users concerning the status of their OTC derivatives positions (*e.g.*, value, profits and losses)? If so, what kind of reports should be required, and how often should such reports be made?

64. Should dealers be required to collect information concerning their end-user customers? If so, what kind of information? Should dealers be required to retain documentation in their files concerning such information, and if so, what kind of documentation (*e.g.*, confirming that particular information has been collected and reviewed by management to assure transactions are in conformity with the end-user's investment goals and policies)?

65. What sales practice rules, if any, should apply to transactions where a dealer is acting as an agent or broker to facilitate a principal-to-principal transaction between two end-users? Similarly, what sales practice rules, if any, should apply to dealer-to-dealer transactions where both dealers are trading for their own proprietary accounts?

66. Should dealers have to comply with different sales practice standards in dealing with end-users having different levels of sophistication, based, for example, or portfolio size, investment experience, or some other measure? If so, please elaborate.

67. Should dealers be required to follow any supervision requirements in connection with the activities of sales personnel and other employees responsible for handling the accounts of end-user customers? Should complex or highly leveraged transactions require prior approval by senior management of the dealer?

68. What is the appropriate regime for formulating and overseeing the implementation and enforcement of possible sales practices rules, including the appropriate roles of the Commission, other financial regulators and industry self-regulatory bodies?

9. Recordkeeping

The Commission has not required any recordkeeping requirements for OTC derivatives dealers or other OTC market participants. Having retained authority over fraudulent and manipulative behavior in the OTC derivative market, the Commission wishes comment on whether some recordkeeping requirements would facilitate its exercise of that authority. Provisions requiring the retention of written records of transactions with counterparties, for example, might be considered. The Commission requests comment on whether there should be specific recordkeeping requirements for transactions in the OTC derivatives markets and, if so, what types of records should be kept and by whom.

Request for comment. 69. Are recordkeeping requirements for participants in the OTC derivatives markets needed? If so, what records should be required? Who should be required to keep them?

10. Reporting

The Commission currently does not impose reporting requirements on OTC derivatives market participants.[88] The

and systemic risk. See CFTC OTC Derivatives Report at 112–122. It may also be appropriate to consider whether to require dealers to disclose to prospective end-users other material information concerning OTC derivatives transactions, such as the relationship of the parties, the material terms of the contract, periodic reports of the status of the end-user's account, information on how the value of the OTC derivatives instrument would be affected by changes in the markets for the underlying components, and other similar information.

[87] 17 CFR 35.1(b)(2) (1997).

[88] The DPG has established voluntary reporting requirements. See DPG Framework at 23–25. The DPG has committed to regular periodic reporting and to respond in good faith to ad hoc requests for additional information by the CFTC. Id. at 1. The DPG member firms currently provide to the Commission on a quarterly basis a report detailing for each member except Credit Suisse First Boston: (1) a Credit-Concentration Report listing (on a "no-names" basis) the top 20 OTC derivatives exposures and, for each exposure, the internal credit rating, the industry segment, the current net exposure, the next replacement value, the gross replacement values (receivable and payable) and the potential additional credit exposure (at a ten-day, 99-percent confidence interval); (2) a Portfolio Summary

Commission requests comment on whether specific reporting requirements for participants in the OTC derivatives markets are needed and, if so, what reports should be made and by whom. If the Commission were to establish reporting requirements, it would coordinate with other regulatory agencies and, to the extent possible, accept reports provided to other regulatory agencies in satisfaction of the Commission's requirements. The Commission solicits comment concerning how these goals might best be accomplished.

Request for comment. 70. Should the Commission establish reporting requirements for participants in the OTC derivatives markets? If so, what information should be reported? By whom?

C. Self-Regulation

Having identified areas in which current exemptions might be modified, the Commission is also interested in the views of commenters concerning whether, and to what extent, any needed changes concerning the oversight of the OTC derivatives market could be accomplished through initiatives of industry bodies either voluntarily or through a self-regulatory organization empowered to establish rules and subject to Commission oversight. The Commission notes that several industry organizations already exist with an interest in maintaining and improving the integrity of the OTC derivatives marketplace. These organizations include, among others, the Derivatives Policy Group, the International Swaps and Derivatives Association, the Group of Thirty, and the End-Users of Derivatives Association. Industry groups have already issued a number of voluntary initiatives aimed at reducing risks and promoting stability and integrity in the OTC derivatives marketplace.[69] The Commission is interested in exploring the extent to which concerns described in this release might be addressed, and adequate oversight of the OTC derivatives marketplace might be attained, through industry bodies or through self-regulatory organizations.

Request for comment. 71. How effective are current self-regulatory efforts? What are their strengths and weaknesses?

72. Are there particular areas among those discussed above where self-regulation could obviate the need for government regulation?

73. Please discuss the costs and benefits of existing voluntary versus potential mandatory self-regulatory regimes.

74. If a self-regulatory regime were adopted, what mechanism would best assure effective oversight by the Commission?

75. How best can the Commission achieve effective coordination with other regulators in connection with the oversight of the OTC derivatives market?

IV. Summary of Request for Comment

Commenters are invited to discuss the broad range of concepts and approaches described in this release. The Commission specifically requests commenters to compare the advantages and disadvantages of the possible changes discussed above with those of the existing regulatory framework. In addition to responding to the specific questions presented, the Commission encourages commenters to submit any other relevant information or views.

Issued in Washington, D.C. this 6th day of May, 1998, by the Commodity Futures Trading Commission.

By the Commission (Chairperson BORN, Commissioners TULL and SPEARS; Commissioner HOLUM dissenting).

Jean A. Webb,

Secretary of the Commission.

Dissenting Remarks of Commissioner Barbara Pedersen Holum, Concept Release, Over-the-Counter Derivatives

In Section 4(c)(1) of the Commodity Exchange Act, Congress authorized the Commission to exempt certain transactions "[i]n order to promote responsible economic or financial innovation and fair competition." Indeed, it appears that the dramatic growth in volume and the products offered in the OTC derivatives market may be attributed in part to the Commission's past exemptive action. In the spirit of the Commission's ongoing regulatory review program, it is appropriate to examine the continuing applicability of the existing exemptions, focusing on the expanding economic significance of the OTC market. However, in my judgement, the release goes beyond the scope of regulatory review by exploring regulatory areas that may be inapplicable to an OTC market. Accordingly, I am dissenting from the majority's decision to issue the Concept Release on OTC Derivatives in its current form.

Dated: May 6, 1998.

Barbara Pedersen Holum,

Commissioner.

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listing, by credit rating category and industry segment, the current net exposure, net replacement value, and gross replacement values; (3) a Geographic Distribution listing, by country, the current net exposure, the net replacement value, and the gross replacement values; (4) a Net Revenues Report listing, by product category and month, the net revenue; and (5) a Consolidated Activity Report listing, by product category, the aggregate notional amount.

[69] See, e.g.: Framework for Voluntary Oversight, supra; Principles and Practices for Wholesale Financial Market Transactions, supra; and Global Derivatives Study Group, Group of Thirty, Derivatives: Practices and Principles, supra.

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Parts 430, 431, 432, 433, 436, 440, 441, 442, 443, 444, 446, 448, 449, 450, 452, 453, 455, and 460

[Docket No. 98N-0211]

Removal of Regulations Regarding Certification of Antibiotic Drugs; Companion Document to Direct Final Rule

AGENCY: Food and Drug Administration, HHS.

ACTION: Proposed rule.

SUMMARY: The Food and Drug Administration (FDA) is publishing this companion proposed rule to the direct final rule, published elsewhere in this issue of the Federal Register, which is intended to repeal FDA's regulations governing certification of antibiotic drugs. The agency is taking this action in accordance with provisions of the Food and Drug Administration Modernization Act of 1997 (FDAMA). FDAMA repealed the statutory provision in the Federal Food, Drug, and Cosmetic Act (the act) under which the agency certified antibiotic drugs. FDAMA also made conforming amendments to the act.

DATES: Comments must be received on or before July 27, 1998.

ADDRESSES: Submit written comments to the Dockets Management Branch (HFA-305), Food and Drug Administration, 12420 Parklawn Dr., rm. 1-23, Rockville, MD 20857.

FOR FURTHER INFORMATION CONTACT: Wayne H. Mitchell or Christine F. Rogers, Center for Drug Evaluation and Research (HFD-7), Food and Drug Administration, 5600 Fishers Lane, Rockville, MD 20857, 301-594-2041.

SUPPLEMENTARY INFORMATION:

I. Background

As described more fully in the related direct final rule, section 125(b) of FDAMA (Pub. L. 105-115) repealed section 507 of the act (21 U.S.C. 357)